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Asset Allocation: Investing for the Long Term

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If you're planning for the long term, asset allocation may be the key to effectively managing the risk and return profile of your investment portfolio. Below we explain what asset allocation is, how it works, and why it may be the best investment approach for you to realize your financial goals.

Asset allocation refers to an investment strategy in which investment portfolios are diversified across multiple asset classes to minimize risk. Asset allocation works because asset classes respond to changing economic and political conditions in different ways. So, including more than one asset class increases the probability that some investments in the portfolio will, over time, provide positive returns, even if others are flat or lose value. It's basically the prudent investor's version of the old proverb, "Don't put all your eggs in one basket".

There is a significant body of research supporting the effectiveness of asset allocation in constructing portfolios. In a landmark paper published in 1986, "Determinants of Portfolio Performance," Gary Brinson, L. Randolph Hood, and Gilbert L. Beebower found that asset allocation was the primary determinant of a portfolio's return variability.*

In other words, the most efficacious way to manage risk and return in building an investment portfolio is to allocate investments across asset classes with the expectation that these asset classes will perform as they have in the past under similar market conditions.

Asset Classes

An asset class is a group of financial instruments that have common features and characteristics and behave similarly in the marketplace. The three major asset classes included in most investment portfolios are:

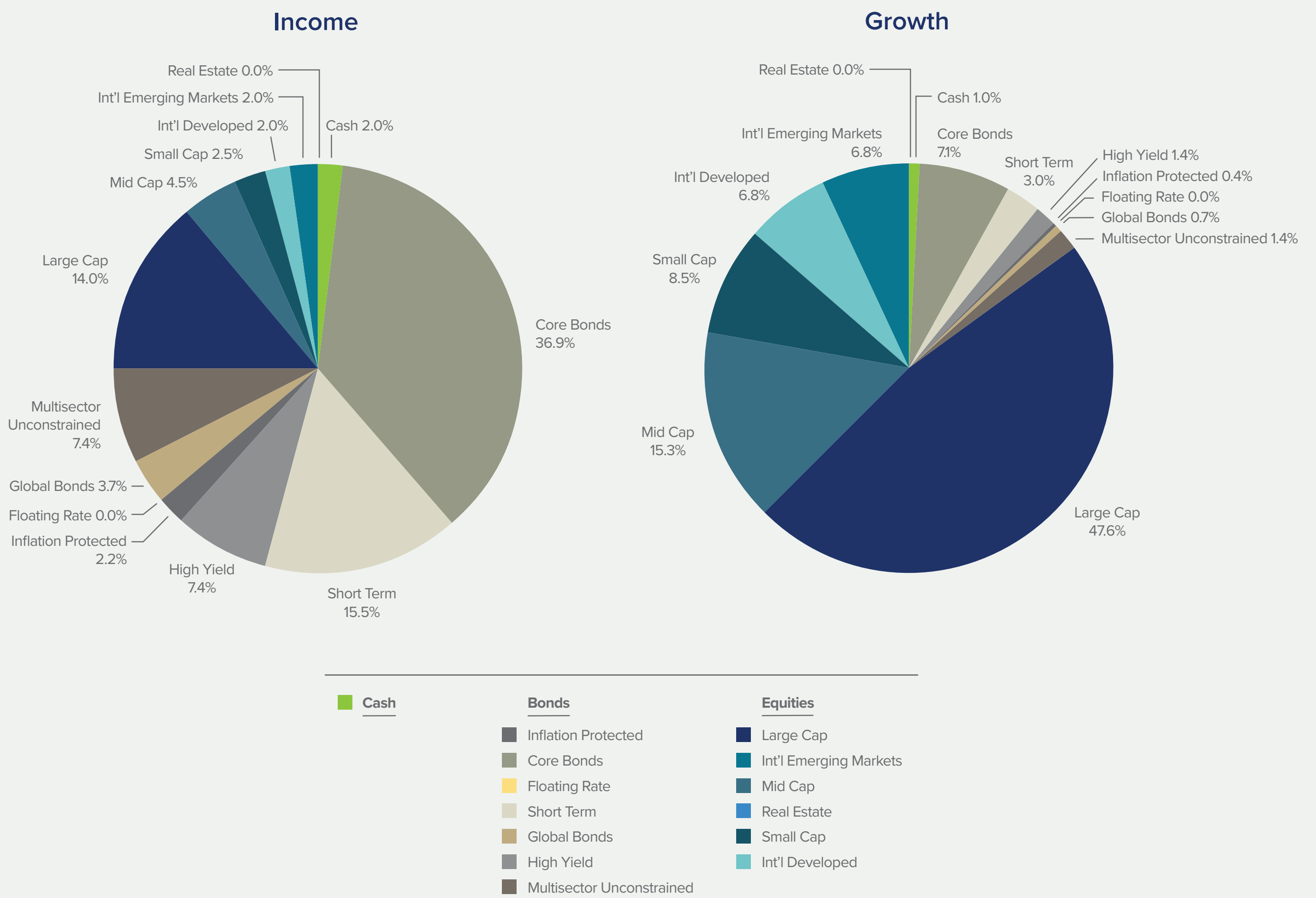
- Stocks or equities: shares of ownership issued by publicly traded companies
- Bonds or other fixed-income investments: debt securities that pay a rate of return in the form of interest
- Cash or cash equivalents, such as money market funds

To better manage risk, portfolio managers often divide these major asset classes into sub-classes. Stocks, for example, may be subdivided by capitalization into large, medium, and small, or by style into stocks that are either value or growth-oriented. Bonds may be segregated by type of issuer (for example: Corporate or Government), quality, or time to maturity.

Some portfolio managers also allocate to asset classes beyond these traditional options. Such alternative asset classes might include real estate holdings, commodities, hedge funds, or private equity. The primary goal in the kind and number of asset classes used is to best diversify risk given specific return targets.

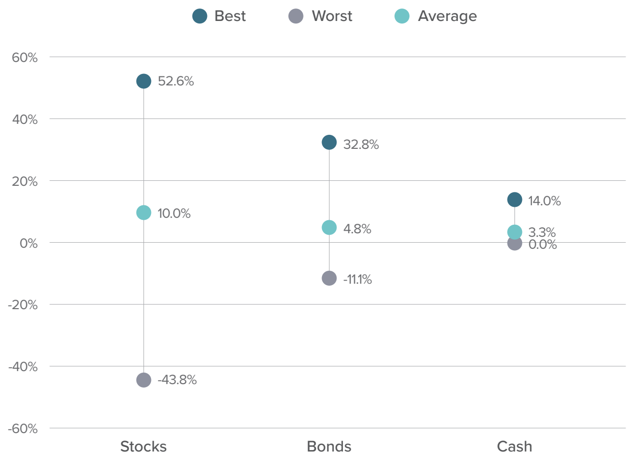
Asset Class Allocations

The pie charts below represent asset class allocations for Income and Growth portfolios as recommended by Washington Trust for June 2022. Allocations in these models may change over time based on shifts in our long-term capital market assumptions. Also, the tactical and strategic allocations for individual clients may vary somewhat from those prescribed here, depending on factors specific to clients' goals, resources, tax situation, liquidity, and risk tolerances.



Each asset class tends to have different risk/return profiles. The graph below shows the historical risk and return of stocks, bonds, and cash from 1928 to 2021. At 10% annually, stocks have the highest average return, but also the highest risk, as shown by the wide gap between best and worst year's returns. In contrast, cash is by far the safest investment, although it provides the lowest average return at just 3.3%. Bonds fall somewhere in the middle.

Annual Returns for Stocks, Bonds, & Cash from 1928 to 2021



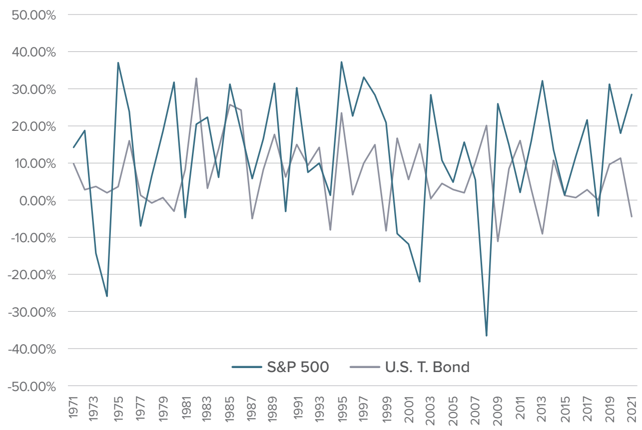
Source: Historical Returns on Stocks, Bonds and Bills: 1928 – 2021, NYU, January 2022.

Portfolio Construction – Diversification and the Efficient Frontier

Investors have different goals for their investments and different tolerances for risk, but virtually all investors want a portfolio that maximizes expected return for a given level of risk. Modern Portfolio Theory was developed by Nobel Prize winner, Harry Markowitz, to allow investors to assemble such "optimal" portfolios.

Asset classes have different risk return profiles and often behave differently under similar market conditions. This means that at certain times in the market, some asset classes may have strong returns while others suffer losses. Stated more precisely, asset classes may be "negatively correlated" regarding their return variability. Markowitz showed that by diversifying assets across asset classes that are negatively correlated, investors can mitigate overall portfolio volatility while still meeting return targets.

Historical Return Comparison
S&P 500 / U.S. Treasury Bond

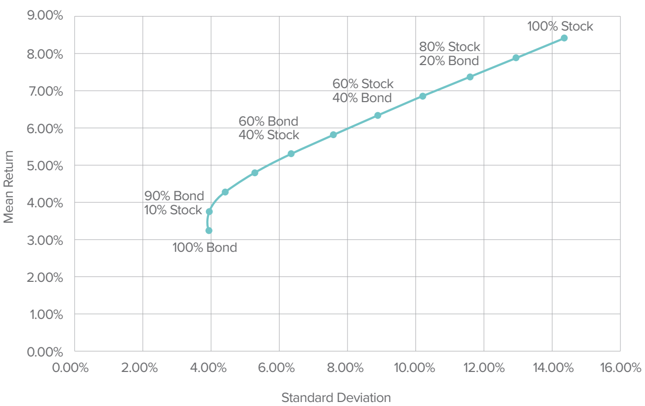


The chart above shows the annual returns of stocks vs bonds since 1971. It suggests that the correlation in the return streams is relatively low, often with bond returns moving in the opposite direction of stocks or in the same direction but with much lower magnitude. As a result, combining the two asset classes in a portfolio can optimize the portfolio's risk/return profile.

Source: Historical Returns on Stocks, Bonds and Bills: 1928 – 2021, NYU, January 2022.

To illustrate his theory, Markowitz introduced the concept of the efficient frontier, a set of optimal portfolios that offer the highest expected return for a defined level of risk or the lowest risk for a given expected return. Once a risk or return target is specified, a portfolio, which falls on the efficient frontier curve, with the combination of asset classes that will deliver the optimal risk-return balance for each target, can be constructed.

Efficient Frontier



The chart above shows the efficient frontier for a portfolio made up of two asset classes: stocks, as represented by the S&P 500, and bonds, as represented by the iShares Core Aggregate Bond ETF. Monthly returns were used from 10/2003 to 06/2022. The points on the curve represent "optimal portfolio applications for given risk or return levels." Note that while bonds are generally considered less risky than stocks, due to negative correlations between the asset classes, a 90% bond/10% stock portfolio provides greater return for less risk than a 100% bond portfolio.

Source: Yahoo Finance

Strategic Allocation and Tactical Allocation

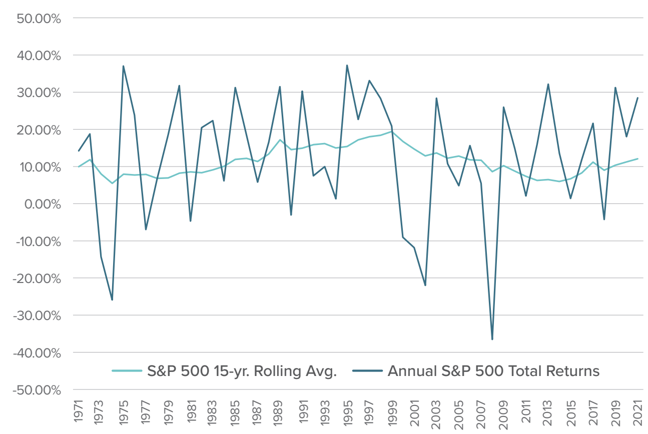
Portfolio managers typically apply strategic and tactical asset allocation to portfolios.

Strategic allocation is built on the foundation of the efficient frontier and is guided by the longer-term investment objectives and risk tolerance of the investor. Strategic allocations are generally based on 10-30 year capital market assumptions regarding the performance of the asset classes included in the portfolio, and, as a result, tend to be relatively stable, changing only when long-term market expectations evolve.

In contrast, *tactical allocation* increases or decreases exposure to certain asset classes based on shorter-term movements in the market, for example, inflation rate fluctuations or other changes attributable to the business cycle. Tactical allocation shifts usually fall within bands around core strategic allocations, giving greater or lesser weight for a period of time to specific asset class holdings.

Tactical allocations allow portfolio managers to adjust strategic allocations to take advantage of short-term market events. If done skillfully, such adjustments can improve the risk-return profile of the strategic allocation.

Strategic & Tactical Allocation Time Frames



This graph compares the rolling 15-year returns of the S&P 500 to the index's annual returns. The 15-year time frame is representative of the longer-term viewpoint typically taken by the strategic allocator who is concerned with performance of asset classes over a 10- to 30-year period. The annual returns represent the tactical allocator's interest in making portfolio adjustments in response to short-term return fluctuations.

Source: Historical Returns on Stocks, Bonds and Bills: 1928 – 2021, NYU, January 2022.

Portfolio Monitoring and Rebalancing

Over time, under shifting market conditions, strategically allocated portfolios can drift from their original allocations, compromising their intended risk/return profiles. In such instances, rebalancing the portfolio back to the original allocation is often advisable.

Rebalancing is the process of selling from highly appreciated asset classes to lesser appreciated classes to return to original allocations. Portfolio managers may rebalance portfolios on a regular schedule, for example, annually, or, on an ad hoc basis when volatility in the market causes significant imbalances in the strategic allocation.

It should be noted that there are extraneous factors to consider in determining the frequency and timing of rebalancing, as well as in the selection of securities to be traded. Excessive trading can be costly, so it is important to rebalance only when necessary. Trading also may have tax implications that deserve consideration, as investors strive to maximize after-tax gains in their portfolios.

Don’t put all your eggs in one basket

Asset allocation has proven to be an essential tool in diversifying investment portfolios and managing risk. Working with an experienced and knowledgeable wealth team to find the allocation that aligns with your unique return goals and risk tolerance can be the key to a successful long term financial plan and to the full realization of your life goals.

We encourage you to reach out to your investment team or Wealth Advisor with any concerns about your investment portfolio or questions about the financial markets or the economy.

Connect with a wealth advisor today

Call 800-582-1076 or visit us at washtrustwealth.com

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* Financial Analysts Journal, Volume 42, pages 133 - 138, July, 1986.