RAYMOND JAMES

Asset Allocation

A Guide to the Fundamentals of Portfolio Construction

WHAT IS ASSET ALLOCATION?

As its name suggests, asset allocation is the collective percentage of investable capital 'allocated' to each 'asset' class. The conventional '60/40' stock and bond portfolio showcases a traditional asset allocation model. Namely, 60% of investable capital is allocated to stocks while the remaining 40% of investable capital is allocated to bonds (see chart).

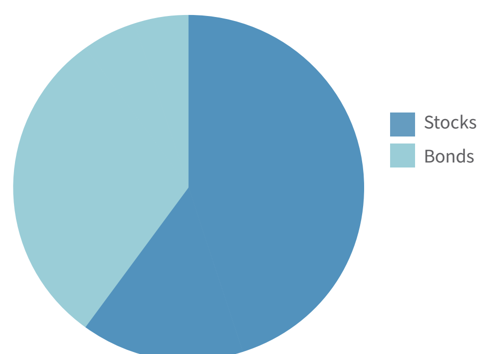
ASSET CLASSES

Traditional asset classes fall into two broad categories: **equities** (stocks) and **non-equities** (bonds and cash). **Alternative investments** represent a non-traditional category in modern portfolios. These broad asset classes consist of multiple 'sub' asset classes (see chart). For example, large-capitalization U.S. equities and international equities are sub asset classes within the broad equity asset class. U.S. Treasury notes and investment grade bonds are sub asset classes within the broad non-equity asset class. Managed futures and long/short strategies are sub asset classes within the broad alternative asset class.

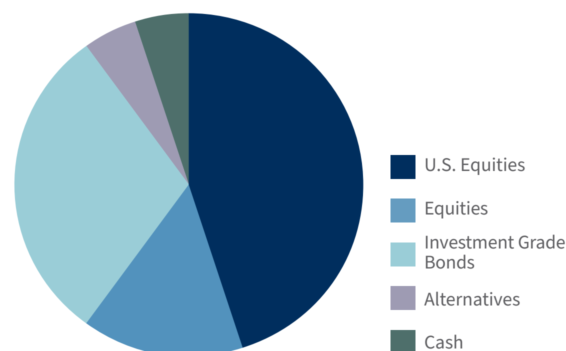
THE IMPORTANCE OF ASSET ALLOCATION

Asset allocation is the most predominant component of portfolio performance. Studies have shown that asset allocation accounts for approximately 86% of portfolio returns.[1] In short, the percentage of assets allocated to equities vs. non-equities is the principal determinant of portfolio performance over time.

60/40 Portfolio



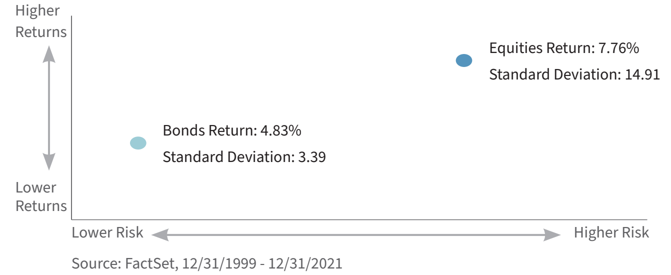
Asset Classes



[1] Brinson, Beebower, Hood. *Determinants of Portfolio Performance*. 1985-1994.

RISK PREMIUM

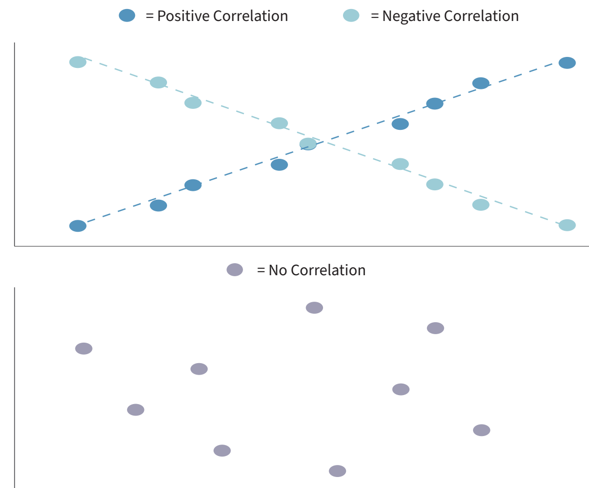
Given that asset allocation determines a preponderance of portfolio returns, an investor may be tempted to allocate all of his assets to the asset class with the most upside potential. Generally speaking, asset classes with the greatest upside potential also have the greatest downside potential. Conversely, asset classes with the least upside potential also have the least downside potential. This is known as **risk premium**. Over time, an investor should be rewarded relative to the risk he assumes.



Source: FactSet, 12/31/1999 - 12/31/2021

CORRELATION

Effective asset allocation can also insulate portfolio returns from excess volatility. This can be achieved by allocating capital with respect to the **correlation** of each asset to other assets within the portfolio. Correlation measures the degree to which assets move in the same or opposite directions. This measure ranges from +1 to -1. Assets which are positively correlated (+1) move in the same direction, while assets which are negatively correlated (-1) move in opposite directions. Assets which have no correlation (0) do not move in relation to each other (see charts). By allocating a percentage of capital to negatively or non-correlated assets, portfolio returns can be insulated from market volatility.



DIVERSIFICATION

The performance of different asset classes varies year to year. The best performing asset class in one year can easily be the worst performing asset class next year (see below). Past results are not indicative of future performance. The ability to consistently and reliably pick the best performing asset class each year has proven to be a nearly impossible task. A balanced, well-diversified portfolio has proven to be one of the best ways to capture consistent returns over time. A balanced portfolio offers exposure to the upside potential of multiple asset classes while attempting to limit downside risk (see chart below).

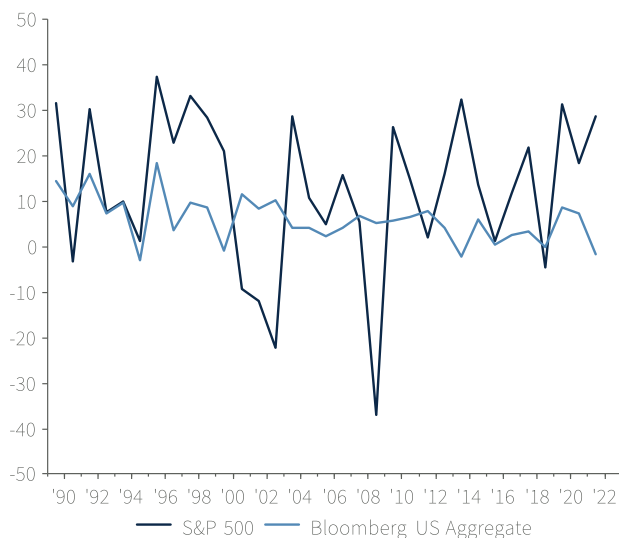
2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Real Estate 40.4%	Fixed Income 7.8%	Non-US Equities 17.0%	US Equities 32.4%	Real Estate 14.3%	US Equities 1.4%	Real Estate 15.3%	Non-US Equities 24.8%	Cash & Cash Alternatives 1.8%	US Equities 31.5%	US Equities 18.4%	Real Estate 38.6%
Commodities 16.7%	Blended Portfolio 2.3%	US Equities 16.0%	Non-US Equities 21.6%	US Equities 13.7%	Fixed Income 0.5%	US Equities 12.0%	US Equities 21.8%	Fixed Income 0.0%	Non-US Equities 23.2%	Blended Portfolio 12.5%	US Equities 28.7%
US Equities 15.1%	US Equities 2.1%	Blended Portfolio 11.4%	Blended Portfolio 17.0%	Blended Portfolio 8.0%	Blended Portfolio 0.5%	Commodities 11.4%	Blended Portfolio 15.0%	Blended Portfolio -4.0%	Blended Portfolio 21.1%	Non-US Equities 8.1%	Commodities 27.1%
Blended Portfolio 10.8%	Cash & Cash Alternatives 0.1%	Fixed Income 4.2%	Cash & Cash Alternatives 0.0%	Fixed Income 6.0%	Cash & Cash Alternatives 0.0%	Blended Portfolio 6.9%	Fixed Income 3.5%	US Equities -4.4%	Real Estate 19.5%	Fixed Income 7.5%	Blended Portfolio 14.3%
Non-US Equities 9.4%	Real Estate -2.2%	Real Estate 0.6%	Fixed Income -2.0%	Cash & Cash Alternatives 0.0%	Non-US Equities -2.6%	Non-US Equities 3.3%	Cash & Cash Alternatives 0.8%	Real Estate -7.6%	Fixed Income 8.7%	Cash & Cash Alternatives 0.5%	Non-US Equities 13.2%
Fixed Income 6.5%	Non-US Equities -11.8%	Cash & Cash Alternatives 0.1%	Commodities -9.6%	Non-US Equities -3.9%	Real Estate -24.2%	Fixed Income 2.6%	Commodities 0.7%	Commodities -13.0%	Commodities 5.4%	Commodities -3.5%	Cash & Cash Alternatives 0.0%
Cash & Cash Alternatives 0.1%	Commodities -13.4%	Commodities -1.1%	Real Estate -25.8%	Commodities -17.0%	Commodities -24.7%	Cash & Cash Alternatives 0.3%	Real Estate -0.2%	Non-US Equities -13.6%	Cash & Cash Alternatives 2.2%	Real Estate -13.1%	Fixed Income -1.5%

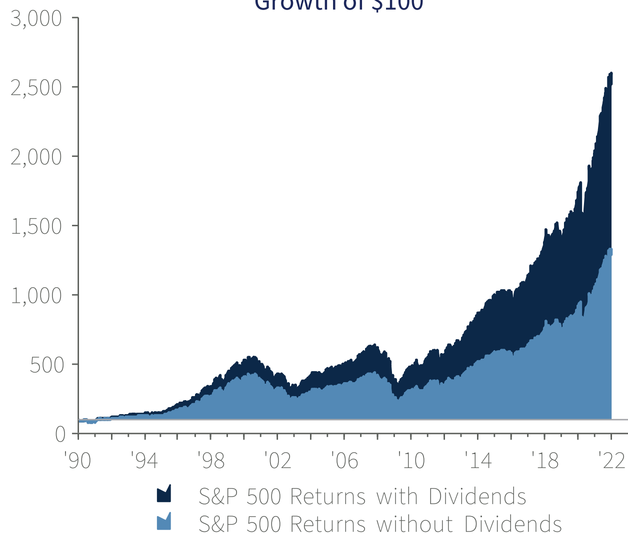
Blended Portfolio Allocation: 45% U.S. Equity / 15% Non-U.S. Equity / 40% Fixed Income; Source: FactSet, as of 12/31/2021

DETERMINING PROPER ALLOCATIONS

As previously indicated, the most crucial determinant of portfolio performance lies in the percentage of assets allocated to equities vs. non-equities. So how should an investor determine his allocations to each asset class?

While equities may offer the best potential for growth over an extended period of time, their returns are often more volatile than bonds. However, while non-equities may offer the best potential for capital preservation, their returns often underperform equities over extended periods (see charts below).





Therefore, a suitable asset allocation must be tailored to an investor's individual **time horizon**, **risk tolerance**, and **investment goals**.

TIME HORIZON

While many factors can affect an investor's ultimate asset allocation, his individual investment **time horizon** will have the most impact. An asset allocation suitable for a young professional at the start of his career is not necessarily suitable for an executive who is nearing retirement. Similarly, a foundation expected to exist in perpetuity may not have the same allocation needs as an operating fund covering an organization's near-term expenses.

For those who have long investment time horizons, higher allocations to equities may provide better potential for growth and wealth accumulation. Conversely, for those with shorter time horizons, higher allocations to non-equities may provide better potential for stability and wealth preservation.

RISK TOLERANCE

Equally important to an investor's asset allocation is **risk tolerance**. Assets with greater upside potential generally carry greater risk. While stocks generally outperform bonds over extended periods of time, they are generally much more volatile and carry a greater risk for loss. Conversely, while bonds generally underperform stocks over extended periods of time, they are generally much less volatile and carry less risk for loss.

If an investor has a low tolerance for risk, a portfolio with a smaller percentage allocated towards stocks and a greater percentage allocated towards bonds may be more suitable. Conversely, a portfolio with a greater percentage allocated towards stocks and a smaller percentage allocated towards bonds may be more suitable for an investor with a high tolerance for risk.

INVESTMENT GOALS

Finally, an investor's asset allocation must align with **investment goals**. If an investor wishes to grow assets over a long period of time, a higher allocation to stocks may be suitable. On the other hand, if an investor merely wishes to preserve wealth and reduce risk for loss, a higher allocation to bonds may be suitable.

An investor's time horizon, risk tolerance, and investment goals are often synthesized in an investment policy statement. A financial advisor is suited and trained to assess the individual needs of an investor and tailor an asset allocation in order to help reach investment objectives.

Source: FactSet as of 12/31/2021. Past performance may not be indicative of future results.

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DISCLOSURES

U.S. EQUITY / STOCKS | Russell 3000 Total Return Index: This index represents 3000 large U.S. companies, ranked by market capitalization. It represents approximately 98% of the U.S. equity market. This index includes the effects of reinvested dividends.

NON-U.S. EQUITY | MSCI ACWI Ex USA Net Return Index: The index is a market-capitalization-weighted index maintained by Morgan Stanley Capital International (MSCI) and designed to provide a broad measure of stock performance throughout the world, with the exception of U.S.-based companies. The index includes both developed and emerging markets.

GLOBAL REAL ESTATE | FTSE EPRA/NAREIT Global Net Return Index: This index is designed to track the performance of listed real estate companies and REITs in both developed and emerging markets. By making the index constituents free-float adjusted, liquidity, size and revenue screened, the series is suitable for use as the basis for investment products. Prior to 2009, this asset class was represented by the NASDAQ Global Real Estate Index.

CASH & CASH ALTERNATIVES | Citigroup 3 Month U.S. Treasury-Bill Total Return Index: This index is a measurement of the movement of 3-month T-Bills. The income used to calculate the monthly return is derived by subtracting the original amount invested from the maturity value.

FIXED INCOME / BONDS | Bloomberg Barclays Capital Aggregate Bond Total Return Index: This index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

COMMODITIES | Bloomberg Commodity Total Return Index: The index tracks prices of futures contracts on physical commodities on the commodity markets. The index is designed to minimize concentration in any one commodity or sector. It currently has 22 commodity futures in seven sectors. No one commodity can compose less than 2% or more than 15% of the index, and no sector can represent more than 33% of the index (as of the annual weightings of the components). The weightings for each commodity included in the Bloomberg Commodity Index are calculated in accordance with rules that ensure that the relative proportion of each of the underlying individual commodities reflects its global economic significance and market liquidity. Annual rebalancing and reweighting ensure that diversity is maintained over time.

ALTERNATIVES | Alternative investments involve substantial risks that may be greater than those associated with traditional investments and are not suitable for all investors. They may be offered only to clients who meet specific suitability requirements, including minimum-net-worth tests. These risks include, but are not limited to, limited liquidity, tax considerations, incentive fee structures, potentially speculative investment strategies, and different regulatory and reporting requirements.

STANDARD DEVIATION | Standard deviation is a measure of the dispersion of a set of data from its mean. It is calculated as the square root of variance by determining the variation between each data point relative to the mean. If the data points are further from the mean, there is higher deviation within the data set. In finance, standard deviation is a statistical measurement; when applied to the annual rate of return of an investment, it sheds light on the historical volatility of that investment. The greater the standard deviation of a security, the greater the variance between each price and the mean, indicating a larger price range.

ADDITIONAL DISCLOSURES | Any charts and tables presented herein are for illustrative purposes only and should not be considered as the sole basis for an investment decision. There can be no assurance that the future performance of any specific investment or investment strategy made reference to be profitable or equal any corresponding indicated historical performance level(s). This information should not be construed as a recommendation. The foregoing content is subject to change at any time without notice. Content provided herein is for informational purposes only. There is no guarantee that these statements, opinions or forecasts provided herein will prove to be correct. Past performance is not a guarantee of future results. Indices and peer groups are not available for direct investment. Any investor who attempts to mimic the performance of an index or peer group would incur fees and expenses that would reduce returns. All investing involves risk. Asset allocation and diversification does not ensure a profit or protect against a loss. Dividends are not guaranteed and a company's future ability to pay them may be limited. Fixed income risks include, but are not limited to, changes in interest rates, liquidity, credit quality, volatility, and duration. International investing involves additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets. U.S. Treasury securities are guaranteed by the U.S. government and, if held to maturity, offer a fixed rate of return and guaranteed principal value. You should only invest in hedge funds, managed futures, structured products, commodities, real estate or other similar strategies if you do not require a liquid investment and can bear the risk of substantial losses.

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