Your Asset Allocation: The Sound Stewardship® Portfolio Construction Methodology Explained

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At **Sound Stewardship**®, we take a principled approach to investing. That means our investment strategies and tactics do not change every time market or economic conditions change. We don't chase returns, we don't buy into the latest fads and trends, and we certainly don't let emotion drive investment decisions.

We do all our investment research in-house, we manage all client portfolios in-house, and we aren't beholden to a particular mutual fund or investment company. With our investment team managing your portfolio, you can expect a portfolio that is free from bias or conflicts of interest and designed to meet your personal objectives while balancing risk and return expectations.
Our portfolio selection process includes ten basic principles:

1) Maintain a long-term perspective.

Markets rise and fall based on short-term risk factors. However, a quick review of any chart showing historical investment returns reveals that the long-term trend for markets is typically up[1]. By maintaining a long-term perspective (5+ years), investors can eliminate a significant portion of timing risk and are much more likely to experience positive returns.

Figure 1 illustrates rolling return data for five-year periods from 1998 through 2012. If you held a broadly diversified portfolio of stocks, bonds, and alternative assets for any five-year period from 1998 through 2012, you would've experienced a positive rate of return. The tech bubble of 2000-2002 and the Great Recession of 2008 are included.

Figure 1: Rolling 5-Year Portfolio Returns[2]

	80/20 mix	70/30 mix	60/40 mix	50/50 mix	40/60 mix	20/80 mix
2002	5.02%	5.38%	5.71%	5.87%	6.06%	6.40%
2003	8.82%	8.71%	8.61%	8.46%	8.21%	8.10%
2004	8.34%	8.39%	8.41%	8.39%	8.20%	8.47%
2005	9.47%	9.11%	8.72%	8.47%	8.07%	7.82%
2006	13.34%	12.50%	11.57%	10.84%	10.01%	8.77%
2007	16.39%	15.05%	13.58%	12.37%	11.12%	8.85%
2008	3.15%	3.34%	3.37%	3.34%	3.47%	3.84%
2009	6.19%	6.30%	6.24%	6.25%	6.25%	6.30%
2010	7.40%	7.56%	7.54%	7.54%	7.49%	7.51%
2011	3.96%	4.52%	4.97%	5.30%	5.63%	6.30%
2012	4.77%	5.27%	5.67%	5.94%	6.19%	6.59%
2013	15.74%	14.86%	13.90%	12.87%	11.87%	9.30%
Average	8.71%	8.58%	8.35%	8.10%	7.84%	7.35%

Returns are based on historical index data for a broadly diversified portfolio of stocks, bonds, and alternative asset classes.
Past performance is not indicative of future results.

The economy goes through cycles of expansion and contraction on a regular basis. Although it can usually be determined where we are in a market cycle, rarely can it be predicted how long expansion or contraction will last.

By maintaining a long-term perspective and staying invested through full market cycles, an investor's chance of achieving a desired rate of return increases greatly while the risk of realizing investment losses diminishes.

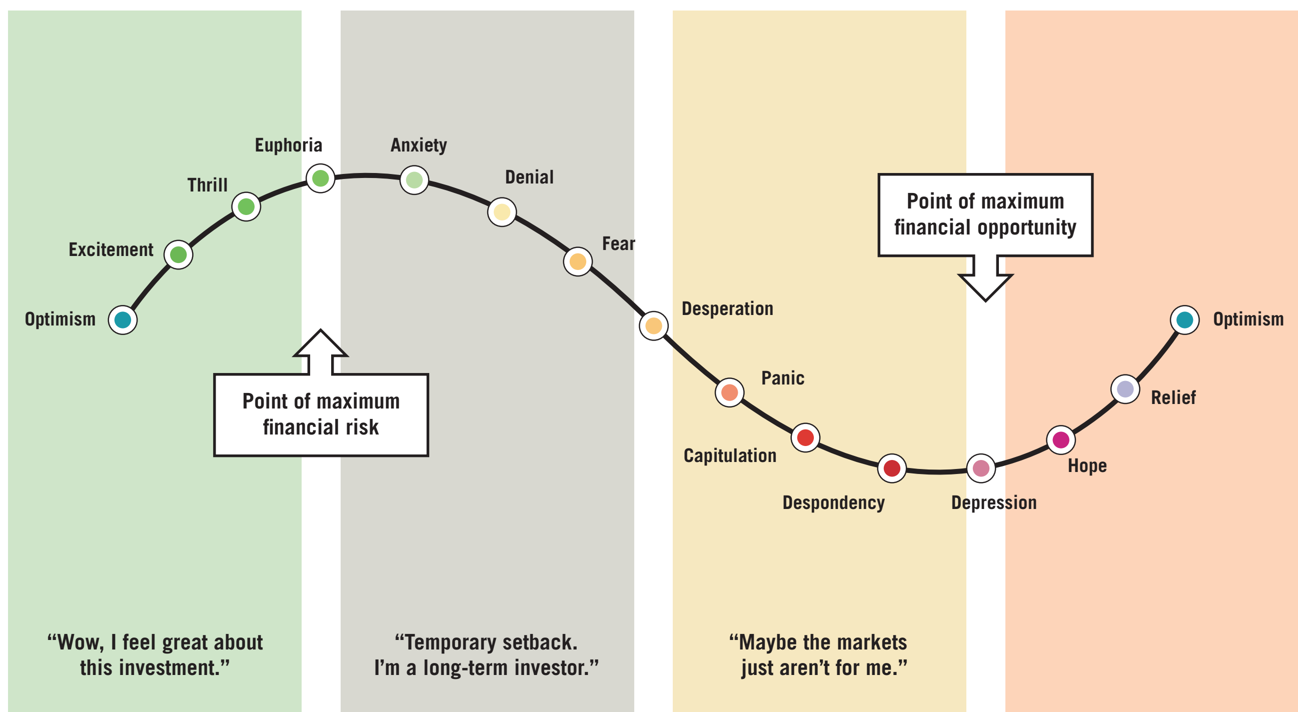
2) Don't let emotion drive investment decisions.

The average investor makes investment decisions based on emotion. **Figure 2** explains the thought process of an investor through the highs and lows of a full market cycle. It's this emotional rollercoaster that causes investors to do the exact opposite of what they should do with their investments.

Each year, the market research firm, Dalbar, releases their study of Quantitative Investor Behavior[3]. The study examines actual investor returns versus index returns. For the twenty years ending in December 2012, the average equity investor experienced a 4.25 percent return while the S&P 500 experienced an average 8.21 percent rate of return over the same period.

The gap between investment return and investor return is a direct result of investors making investment decisions based on emotion and buying or selling at the wrong time. By maintaining a disciplined approach to investing and not letting emotion drive investment decisions, an investor can close the gap and experience improved investment returns.

Figure 2: Emotional Investor



3) Balance risk and return expectations.

When creating a financial plan to achieve a given goal (retirement, college education, etc.), there are four factors that effect goal achievement: time horizon, amount needed, amount saved, and rate of return. Once the four factors have been solved for, an investment allocation can be determined. The investment allocation should fit the risk tolerance of the investor, as well as provide the potential to achieve the required rate of return that accomplishes the goal with the least amount of downside risk. After all, what is the point of chasing after higher returns than what is needed to accomplish the goals if the additional portfolio risk has the likelihood of decreasing the chances of achieving the goal?

With this in mind, we determine a Minimum Acceptable Return (MAR) for each of our clients. This is the long-term target rate of return we seek to achieve as we manage your portfolio throughout your lifetime. There is no guarantee that we will achieve the target rate of return each year, but over time, the MAR provides us with a benchmark for managing risk and return. We build the investment portfolio with the MAR in mind as we seek to achieve attractive investment returns while limiting the downside risk as much as possible (i.e., win by not losing).

4) Evaluate asset classes and sectors over full market cycles.

Within the investing universe, there are a broad range of investment options which are broken down into different asset classes and market sectors. The two major asset types most people are familiar with are stocks and bonds. Within each of these asset types are specific asset classes (i.e., large, mid, and small-cap domestic equity, international equity, emerging markets equity, government bonds, investment-grade corporate bonds, etc.). There are also alternative asset classes such as real estate, precious metals, commodities, futures, long/short equity, and more.

Each of these asset classes displays different risk/return characteristics (see **Figure 3**) and reacts differently to varying market conditions. For example, stocks and bonds tend to be negatively correlated. That is, their prices tend to move in opposite directions compared to each other. If the economy is expected to contract or is viewed to be contracting, equities decline in value as people "rush for the exits," while bonds increase in value as people pour into these relative "safe-haven" investments. Conversely, If the economy is expected to expand or is viewed to be expanding, people feel more comfortable taking on risk and begin to allocate more money toward equities and away from bonds.

Figure 3: 10-year risk/return statistics for Major Asset Classes and Diversified Portfolios

	Total Return	Standard Deviation
MSCI EAFE	4.04	18.17
Barclays Agg	4.55	3.37
20/80 Portfolio	5.8	5.42
40/60 Portfolio	6.82	7.51
S&P 500	7.41	14.62
60/40 Portfolio	7.61	9.71
80/20 Portfolio	8.25	12.19
S&P Mid Cap	10.36	17.69
S&P Small Cap	10.65	19.01

Sources: Morningstar, Barclays Capital, Standard & Poors, MSCI.

Figure 4 shows return statistics for major asset classes over the past ten years. Notice how each of the asset classes performs compared to the others in different market conditions. In up markets, riskier asset classes, like emerging markets and real estate, lead the pack, while bonds and cash offer the lowest returns. In down markets, like in 2008, cash and bonds were two of only three asset classes that offered positive returns, while equities (domestic, international, and emerging markets) were down 34 percent or more.

Figure 4: Asset Class Returns From 2004-2013

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
REITs 31.6%	MSCI EME 56.3%	REITs 35.1%	MSCI EME 39.8%	Barclays Agg 5.2%	MSCI EME 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Russell 2000 38.82%
MSCI EME 26.0%	DJ UBS Cmdty 21.4%	MSCI EME 32.6%	DJ UBS Cmdty 16.2%	Cash 1.8%	MSCI EAFE 32.5%	Russell 2000 26.9%	Barclays Agg 7.8%	MSCI EME 18.6%	S&P 500 32.39
MSCI EAFE 20.7%	MSCI EAFE 14.0%	MSCI EAFE 26.9%	MSCI EAFE 11.6%	Market Neutral 1.1%	REITs 28.0%	MSCI EME 19.2%	Market Neutral 4.5%	MSCI EAFE 17.9%	MSCI EAFE 22.78%
Russell 2000 18.3%	REITs 12.2%	Russell 2000 18.4%	Market Neutral 9.3%	Russell 2000 -33.8%	Russell 2000 27.2%	DJ UBS Cmdty 16.8%	S&P 500 2.1%	Russell 2000 16.3%	Market Neutral 9.27%
S&P 500 28.7%	Market Neutral 6.1%	S&P 500 15.8%	Barclays Agg 7.8%	DJ UBS Cmdty -35.6%	S&P 500 26.5%	S&P 500 15.1%	Cash 0.1%	S&P 500 16.0%	REITs 1.77%
DJ UBS Cmdty 9.1%	S&P 500 4.9%	Market Neutral 11.2%	S&P 500 5.5%	S&P 500 -37.0%	DJ UBS Cmdty 18.9%	MSCI EAFE 8.2%	Russell 2000 -4.2%	Barclays Agg 4.2%	Cash 0.14%
Market Neutral 6.5%	Russell 2000 4.6%	Cash 4.8%	Cash 4.8%	REITS -37.7%	Barclays Agg 5.9%	Barclays Agg 6.5%	MSCI EAFE -11.7%	Market Neutral 0.9%	Barclays Agg -2.02%
Barclays Agg 4.3%	Cash 3.0%	Barclays Agg 4.3%	Russell 2000 -1.6%	MSCI EAFE -43.1%	Market Neutral 4.1%	Cash 0.1%	DJ UBS Cmdty -13.3%	Cash 0.1%	MSCI EME -2.6%
Cash 1.0%	Barclays Agg 1.2%	DJ UBS Cmdty 2.4%	REITs -15.7%	MSCI EME -53.2%	Cash 0.1%	Market Neutral -0.8%	MSCI EME -18.2%	DJ UBS Cmdty -1.6%	DJ UBS Cmdty -9.52%

Sources: Russell, MSCI, Dow Jones, Standard & Poor's, Credit Suisse, Barclays Capital, NAREIT, FactSet, J.P. Morgan Asset Management.

The ultimate goal of diversification is to achieve a desired rate of return with the least amount of downside risk possible.

By understanding the risk/return characteristics that asset classes typically display, we can make strategic decisions on where it makes sense to take on additional risk in order to provide potential for higher returns. We may also determine where it makes sense to avoid certain risks if the risk/return tradeoff is not sufficient to compensate the investor for the added level of risk.

5) Reduce expenses by opting for low-cost ETF's and Index Funds.

Twice yearly, Standard & Poors publishes a scorecard for active managers versus their corresponding indices[4]. As illustrated in **Figure 5**, for the five years ending on 6/30/2013, almost 80 percent of actively-managed mutual funds investing in domestic equities were outperformed by their benchmark indices. The average actively-managed mutual fund has an internal expense ratio of close to 1.5 percent, compared to a typical ETF expense ratio of around .30 percent. That's a difference of 1.2 percent in fees for essentially a 1-in-5 chance of outperforming the index!

Even the 20 percent of managers who do beat their index rarely do so with a high level of consistency. So, not only is it difficult for actively-managed mutual funds to beat their benchmark, but it's even more difficult to pick the funds that will outperform before they do it.

Figure 5: Percentage of U.S. Equity Funds Outperformed by Their Benchmarks

Fund Category	Comparison Index	One Year (%)	Three Years (%)	Five Years (%)
All Large-Cap Funds	S&P 500	59.58	85.95	79.46
All Mid-Cap Funds	S&P Mid-Cap 400	68.88	85.78	81.98
All Small-Cap Funds	S&P Small-Cap 600	64.27	80.19	77.88
Real Estate Funds	S&P U.S. Real Estate Investment Trust	56.83	95.07	80.56

Source: S&P Dow Jones Indices, CRSP. For periods ended June 30, 2013. Outperformance is based upon equal weighted fund counts. All index returns used are total returns. Charts are provided for illustrative purposes. Past performance is not a guarantee of future results.

6) Utilize "Smart Beta" to enhance investment returns.

While most index funds and ETF's are cap weighted (meaning the largest companies in the index are given a proportionately heavier weighting in the index vs. their smaller counterparts), Fundamental Index ETF's weight the index constituents based on a quantitative, rules-based methodology. Companies are analyzed based on their fundamentals (sales, cash flow, dividends, book value) and weighted accordingly.

As shown in **Figure 6**, fundamental indices have been successful in consistently outperforming their cap-weighted counterparts over the past ten years, although the strategy is not 100 percent foolproof. Because the fundamental weightings tend to favor smaller and/or out-of-favor companies, there can be increased volatility for the portfolio, especially in down markets. And, there are still times when the cap-weighted indices have outperformed. It is for these reasons that we balance our equity exposure between cap-weighted and fundamental-weighted indices, as there is definite value in having exposure to both strategies.

Figure 6: Fundamental Index vs. Cap Weighted Index, 10-Year Return History

Index	Annual Return										10-Year Annualized Return
	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004	
FTSE RAFI US 1000	35.66%	17.2%	0.1%	20.0%	42.0%	-40.0%	3.0%	19.7%	6.1%	14.8%	9.35%
S&P 500	32.39%	16.0%	2.1%	15.1%	26.5%	-37.0%	5.5%	15.8%	4.9%	10.9%	7.41%

Sources: Research Affiliates, Standard & Poors.

7) Utilize alternative asset classes to enhance risk-adjusted returns.

Many investments in alternative asset classes were previously unavailable to the masses. However, the advent of exchange-traded funds has now made these unique arrangements available to anyone. Alternative asset classes (like precious metals, commodities, managed futures, real estate, and long/short equity) tend to have low-to-no correlation with a majority of other "traditional" asset classes. It is for this reason that they are excellent tools in providing enhanced portfolio diversification and better risk-adjusted returns.

Alternative asset classes have shown the ability to increase long-term rates of return for a portfolio while also decreasing the downside risk of a portfolio.

Based on industry research on investment returns in slow growth, rising interest rate environments, we've concluded that alternative asset classes will play an increasingly important role in portfolio construction as we turn the page on the historically low-interest rate environment we've enjoyed for quite some time.

8) Regular, rules-based rebalancing

Rebalancing a portfolio back to its target allocation plays an important part in decreasing volatility. It also helps to systematically sell high and buy low as we peel off gains from our winners and redirect those proceeds to underperforming asset classes that may provide opportunity for higher upside potential. We rebalance portfolios on an as-needed basis when the allocations move outside our target range of +/- 5 percent variance.

9) Tax-loss harvesting

Taxes on investment gains can create a sizeable drag on investment returns if a portfolio is not managed tax efficiently.

Tax-loss harvesting (selling holdings when they are trading at a loss in order to capture the loss for tax reporting purposes) offsets capital gains and significantly reduces an investor's overall tax liability.

10) Your Asset Location Strategy

In addition to asset allocation, we practice **asset location**.

Understanding which types of investments should be held in which accounts (based on their tax characteristics) helps us to provide our clients with better after-tax rates of return.

Recent research by TRx[5], a portfolio rebalancing software provider, shows that asset location can improve investor returns by up to one percent on an after-tax basis, all without adding any additional risk to the portfolio. Who wouldn't want that!?

Ultimately, we can't predict or control what happens in the markets or the economy. However, we believe that a principled approach to investing will give investors the best chance for achieving the returns they need in order to accomplish their financial goals. By coupling our portfolio management philosophy with our Purposeful Living Process™ and Sound Stewardship Principles™, you can rest assured that your finances are being well managed and you're on the right path toward success that's meaningful to you.

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Sources:

1. Morningstar Andex chart 2012.

2. The rolling return statistics summarized in Figure 1 are based on historical index returns for the proprietary asset allocation models Sound Stewardship uses for their clients' investment accounts. These returns are simulated using back-tested data. You cannot invest directly in an index.

3. DALBAR Quantitative Analysis of Investor Behavior 2012

4. S&P Indices Versus Active Funds (SPIVA®) Scorecard Mid-Year 2013

5. Easy Risk-Free Return of Over 100 bps per Year!
By Sheryl Rowling, Technology Tools for Today, Volume XI, Issue 4, April 2013

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