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THE ASSET ALLOCATION BALANCING ACT: TO REDUCE RISK, INCREASE DIVERSIFICATION

THOUGHT LEADERSHIP PERSPECTIVES

BY RYAN GELROD, CFA

YOU SEE AND HEAR IT EVERYWHERE: INDIVIDUAL STOCK OR FUND PERFORMANCE IS THE MOST IMPORTANT ELEMENT OF INVESTING.

To us, this approach is counterproductive to long-term financial success because study after study has concluded that the critical factor is the 'mix' of stocks, bonds, and other assets owned. This mix, called asset allocation, is vital to the success or failure of your investment plan. Exacerbating the tendency to concentrate on stock performance, investors often fixate on maximizing return or beating the market. This approach is not a recipe for long-term success. At Fairman Group Family Office, we prefer to focus on establishing an appropriate risk level for a portfolio. After all, an investment plan is of no value if the investor can't maintain positions through all phases of a market cycle.

The fourth quarter of 2018 provided investors an opportunity (though it was quite unpleasant) to re-evaluate their portfolios with the increase in market volatility. Prior to that, we experienced over five years of below average volatility levels. During that time of relative stability, many investors' portfolios drifted towards higher risk levels—trying to maximize returns, and unintentionally, migrating to allocations that exceeded their risk tolerance. While the fourth quarter may have felt unpredictable, the volatility levels were only modestly above the long-term averages, and less than half the levels experienced during the financial crisis.

If the declines in the fourth quarter made you uncomfortable, consider taking the time now to adjust your asset allocation and risk level to one you will be able to live with through both good and bad periods.

DIVERSIFICATION

The easiest way to reduce risk in a portfolio is to increase diversification. Diversification does not mean just adding more securities or funds to a portfolio; it means adding asset classes that respond differently to various economic factors and market events, such as a recession. Ideally, some of the asset classes are moving up, while others are moving down, or at least moving at different rates. While counterintuitive, adding an asset class that is quite risky by itself, such as emerging market equity, can actually serve to reduce the risk of the portfolio as a whole, because it doesn't move in lockstep with some of the other asset classes.

Diversification provides many benefits to a portfolio, but one of the hardest parts for investors to accept is that it virtually guarantees that you will always have underperforming asset classes in your portfolio. Fortunately, it also creates a strong likelihood that you will own the best performing asset classes as well. The key to a diversified portfolio is recognizing that it is extremely difficult to predict which asset classes will outperform in the future, and that it makes sense to have an allocation across an array of asset classes at all times.

The belief that diversification is critical and that short-term asset class predictions are nearly impossible does not mean that asset allocations should be static. In fact, we revisit our clients' asset allocations annually, or more often if necessary, to reflect changing client desires or situations, as well as updated long-term (10-15 year) capital market assumptions. We use elements of Modern Portfolio Theory (MPT), for which Harry Markowitz was awarded the Nobel Prize, to help clients establish an asset allocation with a level of expected risk and return appropriate for their individual situation. The model helps us to select an optimized asset allocation for each client, without basing the results on feelings or hunches that can be biased by short-term events.

Asset allocation is a key element of our investment process. We believe that diversification, done collaboratively and honestly, will help investors build a balanced portfolio—one that they are confident and comfortable with through all phases of the market cycle.

IF YOU WOULD LIKE TO REVIEW YOUR CURRENT PORTFOLIO AND CONFIRM THAT YOUR ASSET ALLOCATION IS APPROPRIATE, PLEASE CONTACT FAIRMAN GROUP FAMILY OFFICE AT 610.889.7300.

ABOUT FAIRMAN GROUP FAMILY OFFICE

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