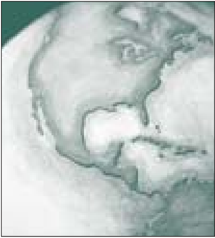

Insights on...

ASSET ALLOCATION

THE BENEFITS OF A STRATEGIC ASSET ALLOCATION PROGRAM

Embracing Risk Management as a Way to Reach Your Investment Goals

In a world of changing markets, investors must take a deliberate approach to capturing opportunities and managing portfolio volatility. Prudent investing requires taking calculated risks while seeking the more consistent performance that comes from reduced portfolio volatility. The most dependable way to do this is through disciplined asset allocation.

Asset allocation is the process of distributing investment capital across various asset classes, each of which may behave differently at a particular time. Through asset allocation, investors can diversify their portfolios and reduce their dependence on the performance of individual investments. The process does more than protect against the downside. By reducing volatility, asset allocation likely will increase the compounded portfolio return.

THE FOUNDATION OF MODERN PORTFOLIO THEORY

Many decades of experience have demonstrated the importance of asset allocation and diversification. Since the 1950s, economists have used mathematical models to calculate the risk and return of particular asset classes and specific investments and how they behave in relation to each other. These studies helped lay the foundation for modern portfolio theory, which provides the underpinning for asset allocation, and proved quantitatively that diversifying by adding a less correlated security or asset class will lower a portfolio's volatility. Of course, correlations are dynamic and change over time. But as a rule, the benefit of reduced volatility increases as the correlation between the performances of two assets decreases.

Modern portfolio theory has significant practical applications for investors. Using models that apply this theory and historical data, it is possible to estimate the expected returns of all possible combinations of assets that create a portfolio. While these estimates aren't accurate forecasts of the future, they do provide a tool investors can use to make informed choices, rather than acting emotionally or purely in response to market conditions. These models allow a portfolio manager to better understand relative levels of risk and return and adjust them to better suit an investor's needs.

EXPANDING OPTIONS MAKE ASSET ALLOCATION MORE IMPORTANT

While asset allocation has always been a wise strategy, it has become even more essential in recent years. A growing array of investment options, both international and domestic, complicates the portfolio construction process. At the same time, the expanding choices offer new ways to increase potential return and manage volatility.

In this climate, the fundamental allocation decision remains the most far-reaching one an investor makes. It establishes the framework for risk, which, in turn, provides a foundation for realizing returns. By better understanding asset allocation, you can embrace risk management as a way to reach your investment goals.

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Asset allocation is more than simply applying a formula. It requires personalized analysis of an investor's risk tolerance, time horizon, liquidity needs and financial objectives.

Asset allocation today involves more than simply applying a formula to an investor's portfolio. Portfolio managers must apply a sophisticated analysis to protect investors' purchasing power against inflation, taking into account an investor's risk tolerance, time horizon, liquidity needs and financial objectives.

The process professional portfolio managers apply to allocate assets appropriately involves five steps: goal identification, investment program design, portfolio construction, implementation and management, and evaluation and dialogue.

STEP 1 – GOAL IDENTIFICATION

How much return – or loss – individual investors will find acceptable is a function of their tolerance for risk. At a macro level, this tolerance is often defined by the market-driving emotions of greed and fear. Portfolio managers need to understand how much emphasis aggressive investors place in seeking returns and, contrarily, how they will react to a loss of principal – even if it is only a temporary or paper loss. Investors accept risk more readily during bull markets, but an investor's risk appetite is truly tested during a bear market.

To gauge your expectations, risk tolerance and cash-flow needs, a portfolio manager may ask:

- What are your overall objectives (for instance, to generate income, maintain liquidity, build capital or preserve wealth) and how important is it that you achieve these goals?
- What are your specific financial goals (improve your current lifestyle and grow funds for your children's education, or maintain your standard of living during retirement)?
- What is the minimum annual return you want this portfolio to deliver?
- Would you be comfortable if your portfolio lost 10% or more in a given year?
- Can you accept the possibility that a particular investment in your portfolio may not produce the return you expect?

Portfolio managers can use the answers to these questions to better identify which asset classes will best reflect your tolerance for volatility and desired return.

HIGH VOLATILITY REDUCES RETURNS

Over time, portfolios with lower volatility generally deliver the higher returns. To illustrate, assume that three sample portfolios all have a starting value of $1 million and an arithmetic average return of 10% per year. During a three-year investment period, their compound rates of return and their ending values vary substantially depending on how volatile they are. The portfolio with the lowest volatility has the highest ending value, while the one with the highest volatility has the lowest ending value.

EXAMPLES	YEAR 1 RETURN	YEAR 2 RETURN	YEAR 3 RETURN	COMPOUND RETURN	ENDING VALUE
Low Volatility	10%	10%	10%	10.00%	$1,331,000
Moderate Volatility	35%	-20%	15%	7.49%	$1,242,000
High Volatility	40%	20%	-30%	5.50%	$1,176,000

For illustrative purposes only; not indicative of future performance.

As a prelude to portfolio design and construction, you must consider how much volatility you can live with on a weekly, monthly or yearly basis. The expected volatility of returns declines as the investment time horizon is extended. If you are comfortable with short-term volatility, you likely will be willing to hold investments longer and thereby lower the overall volatility of your portfolio.

Considering Personal Circumstances

Investors also must factor in personal circumstances, such as current financial obligations and future expenses, which affect how they can invest. Someone who wants to buy a second home or fund children's college education within the next five years may need to preserve principal and maintain a higher level of liquidity. Retirees may require a specific level of income to support their lifestyle.

You should discuss any shorter-term obligations or ongoing income needs with your portfolio manager. If you cannot invest for the long term or are very risk averse, you may need to alter your performance expectations and possibly reassess your financial goals.

Visualizing Risk/Return Tradeoffs

Portfolio managers sometimes use analytical tools to help investors visualize the tradeoffs between risk and return. One popular tool, which is also used to refine portfolio construction (see Step 3), is the Monte Carlo simulation – a computer-generated estimate of investment risk and returns. In essence, Monte Carlo techniques use statistical sampling of potential future returns for a wide range of possible market scenarios to forecast portfolio performance.

Monte Carlo simulations can be helpful in establishing investor expectations. For instance, if an investor wants the portfolio to reach a specific dollar amount by a certain year, a Monte Carlo simulation can address the statistical likelihood that various combinations of investments will achieve this target.

For investors who describe themselves as financially conservative and who favor income over growth, a Monte Carlo simulation can demonstrate how following this approach may take longer to realize their financial goals. A simulation would show how taking a more aggressive approach with the addition of equities – a growth and income strategy – would increase the expected return with only a small increase in risk, which would be expected to produce a significantly higher net worth within the same investment timeframe. Using these projections, investors can decide whether they are comfortable accepting the portfolio volatility needed to reach their goals. It could also show if they need to adjust their financial targets.

STEP 2 – INVESTMENT PROGRAM DESIGN

After gaining an understanding of your risk tolerance and return objectives, your portfolio manager can recommend an investment program.

The portfolio design is based on guidelines established in determining your investment objectives. Sometimes this is formally outlined in a document prepared by your portfolio manager – the investment policy statement – which serves as your total portfolio's business plan. A key component of the plan is to outline the portfolio's strategic asset allocation: an investment program, based on historical returns and your risk tolerance, that is designed to achieve your particular objectives. Strategic allocation has a longer-term outlook, typically of 18 months or more.

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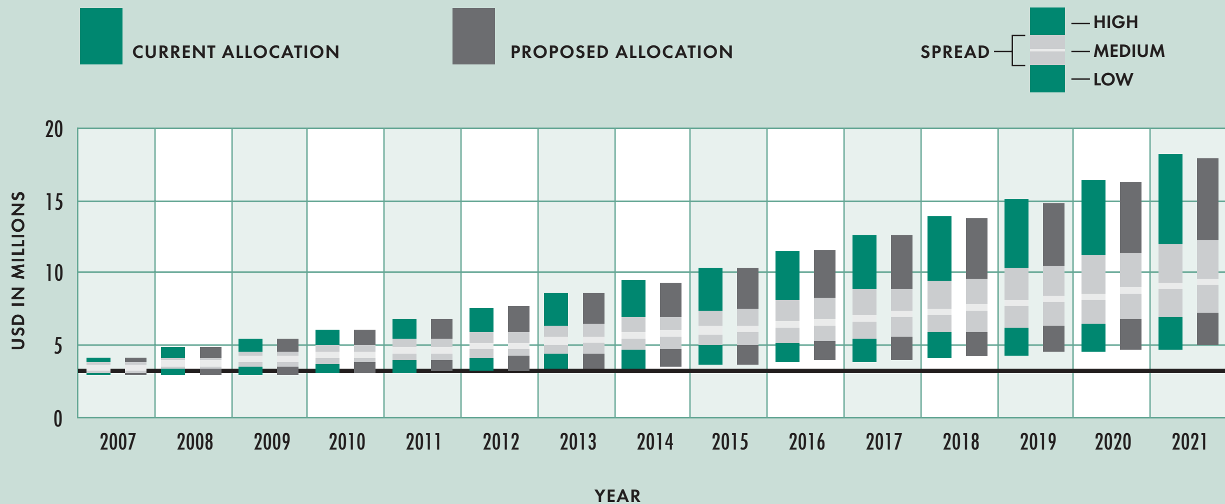
WEALTH PROJECTION ALL YEARS

Current vs. Proposed — Aggregate

This chart examines the projected portfolio values of the current and proposed asset allocations based on a range of historical returns and volatilities of the respective asset classes as a way of illustrating expected valuations over time.



In addition to outlining a recommended strategic asset allocation, the investment policy statement can:

- Profile your financial situation (see Financial Profile Checklist on page 5);
- Define investment objectives;
- Stipulate any assumptions about macroeconomic conditions (such as inflation, interest rates, the political and regulatory environment, and currency risks) that could influence allocations to certain asset classes;
- Establish parameters for the investments, including any constraints such as concentrated positions in particular securities;
- Articulate the expected returns of each asset class and asset sub-class; and
- Indicate whether the primary investment manager will hire other “specialty” managers to fulfill certain asset categories (an increasingly common practice). If so, the investment policy statement can describe the due diligence employed in the search process and the steps for monitoring and measuring these managers’ performance.

The investment policy statement would also address your own investment preferences. For example, a healthcare executive with significant stock options may not want to add more healthcare equities to his or her portfolio. Nor would a real estate developer with significant real estate holdings outside the portfolio necessarily be interested in investing in real estate investment trusts (REITs) or global real estate operating companies. Certain investors may not want to invest in emerging markets or in specific countries, while others may favor socially responsible investments.

Dramatic market conditions, both positive and negative, have always tested investors' resolve to adhere to their strategic plans. A thoughtful investment objective or investment policy statement, reviewed annually, can help keep you focused on your long-term strategy.

STEP 3 – PORTFOLIO CONSTRUCTION

Using the key elements of the investment objective or investment policy statement and your guidelines for asset allocation, your portfolio manager can make recommendations from among a full spectrum of flexible investment options, drawing on active and passive management approaches, or using a hybrid enhanced-indexing approach.

Some people combine active and passive approaches in their total portfolio. This allows them to use passive management for highly efficient asset classes (those in which the benchmark would be difficult to beat) and to exploit less-efficient asset classes by using active managers. Depending on your objectives, your portfolio manager can also employ different investment styles, for example emphasizing growth, value or core investing.

Asset Class Choices Growing

For decades, investors concentrated on three traditional asset classes – stocks, bonds, and cash or cash equivalents. Of the three traditional asset classes, stocks have always been considered the most aggressive and volatile. But equities typically compensated investors for these risk elements with the most attractive total returns, comprised of capital appreciation and dividends. Due to their growing cash flows over time, common stocks have been the best inflation hedge of the three.

Bonds, on the other hand, traditionally produced lower total returns than stocks, but their volatility also was lower. For the most part, they produced a steady cash flow. And cash traditionally was a dollar-in, dollar-out vehicle that preserved investors' principal, but with negligible returns that were often eroded by inflation.

Today the universe has expanded to include what are often referred to as alternative investments: hedge funds, private equity funds, commodities and real estate (apart from the equity in a primary residence or vacation home). These asset classes can further diversify a portfolio because historically their performance is not tied to that of traditional asset classes. Often, especially with hedge funds and private equity funds, investments are limited to qualified investors – individuals with a certain level of income or net worth. Depending on your net worth, liquidity needs and risk tolerance, you may want to consider including alternative investments in your portfolio.

Achieving the Optimal Mix

To increase return and reduce risk, you should include a range of asset classes in your portfolio. No single asset class is a consistent winner. Rather than trying to pick the next hot asset class – and missing – investors who diversify choose an assortment of assets. At any given moment, some will be winners and others will not.

FINANCIAL PROFILE CHECKLIST

Throughout the asset allocation process, it is important to supply the portfolio manager with all relevant information, and update that information as your situation changes. Here are some key items to cover:

1. Amount of investable assets;
2. Investment time horizon;
3. Liquidity needs;
4. Amount of principal you want to protect;
5. Maximum sum you can afford to lose;
6. Goals for principal appreciation;
7. Willingness to use leverage techniques, such as borrowing or use of derivatives, for investing purposes;
8. Interest in socially responsible investment strategies;
9. Tax considerations (which could affect choices between tax-free or tax-deferred investments, and between short-term or long-term capital gains);
10. Retirement assets held in corporate plans;
11. Anticipated liquidity events, such as an initial public offering, sale of a business or real estate; and
12. Any asset concentrations.

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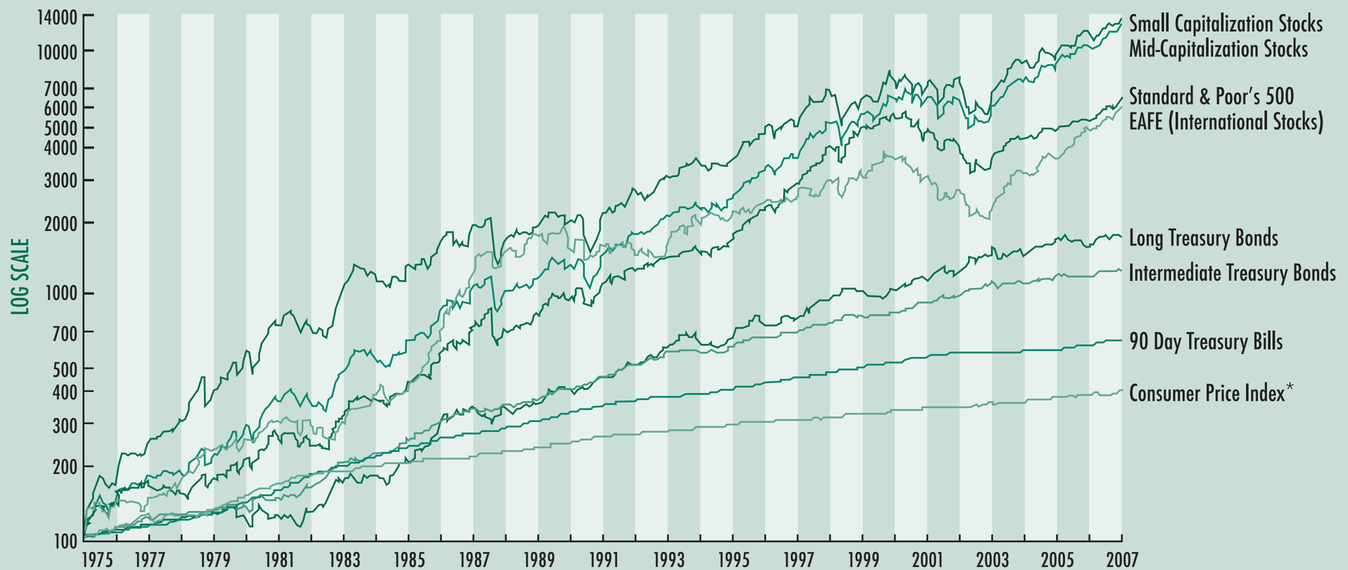
Diversifying investments among different market segments within each asset class also increases the likelihood of higher overall returns. How you do this will depend on the type of asset involved. With equities, for example, portfolio managers may invest in an assortment of industries, in companies of various sizes and in different countries. With fixed-income securities, diversification takes into account the differences between corporate and government bonds, interest rates, the creditworthiness of the issuer and whether the bonds are callable.

Some investors think, erroneously, that by investing entirely in fixed-income securities they can escape risk. But it's actually riskier to hold an undiversified fixed-income portfolio than to construct a more diversified portfolio including equities or alternative investments. Even the most conservative investors who express no tolerance for the volatility of the equity markets may be able to enhance their returns at the same risk levels by adding a minority position of equity securities and alternative investments to their allocation.

A Monte Carlo simulation can be useful during this process by illustrating how adjusting the asset allocation (for instance, by adding alternative investments) can affect the potential long-term results of your portfolio.

WEALTH INDICES OF SELECTED INVESTMENTS
Year End 1974 through May 2007



**CPI data for May 2007 is preliminary*

This chart shows the growth of $100 over time in several asset categories. Different asset classes serve different purposes in investment portfolios. The CPI shows the effect of inflation, which erodes the real return of the asset classes.

Sources: Standard and Poor's Corporation; Ryan Labs, Inc.; Russell investment Group; Barra; Morgan Stanley; Lehman Brothers' Bureau of Labor Statistics.
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STEP 4 – IMPLEMENTATION AND MANAGEMENT

Making the initial investments for a portfolio is just the beginning. Long-term success requires on-going management to keep investments aligned with the initial objectives. Here too, a strategic asset allocation plan provides a guide for keeping the portfolio on track.

Rebalancing a portfolio to maintain the strategic asset allocation calls for discipline. It can be done with a preset frequency – for instance, annually. But an even better approach is to rebalance when the percent of certain asset classes deviates from the original allocation.

At the same time, portfolio managers' continuing role involves tactical asset allocation: making any necessary adjustments occasioned by new laws and changing economic conditions. For example, a portfolio manager may make a tactical decision to reduce the allocation to a specific investment that has become more volatile or overvalued, or to capture an opportunity in the market by increasing the allocation to an undervalued investment.

Reacting to interest rate changes is another example of tactical asset allocation. Rising interest rates caused by inflationary pressures have historically pushed bond prices lower, resulting in disappointing total returns for fixed-income instruments. Interest rates have also been a critical factor in the valuation of common stocks because equity multiples have had a negative correlation with interest rates over time. Higher inflation has usually compressed earnings, with a significant effect on equity total returns. Portfolio managers can suggest changes to reflect such developments.

Likewise, in global markets, portfolio managers must pay close attention to currency revaluations. Currency changes can erode a country's seemingly attractive high nominal rates, particularly in high-inflation markets. With foreign equities, investors should consider earnings expectations for the market overall and for individual securities. International bond investors should take into account spreads between any two jurisdictions, such as U.S. Treasury rates compared to British Pound Sterling government notes.

A portfolio manager's approach to tactical asset allocation may depend on whether an account is taxable or tax-deferred. With taxable accounts, the portfolio manager must weigh the short-term capital gains tax with the benefits of implementing tactical changes.

STEP 5 – EVALUATION AND DIALOGUE

A regular dialogue allows your portfolio manager to evaluate changes in your needs and in the investment landscape and adjust your portfolio accordingly. Communication plays an important role in helping investors track and evaluate portfolio performance.

The continuing conversation between you and your portfolio manager should consider the portfolio's performance, relevant events in your life and macroeconomic developments that may affect your investments. Any of these factors may need to be addressed by rebalancing the portfolio.

Personal circumstances, such as a change in employment or marital status, may be an occasion to change your investment goals and reallocate accordingly. So could the addition of new wealth – such as the result of selling formerly illiquid assets.

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THE IMPORTANCE OF STRATEGIC ASSET ALLOCATION

Asset allocation remains the primary factor governing the volatility of long-term investment results. By using prudent asset allocation strategies, you can structure your portfolio to better deal with market dynamics.

By its nature, investing involves tradeoffs. Investors who understand the benefits of diversification can make better decisions about which path to choose. Intelligent asset allocation is the single best tool you and your portfolio manager can use to manage investment risk. It also exerts the most powerful influence on long-term portfolio return.

Achieving a well-diversified portfolio requires discipline and an on-going dialogue between you and your portfolio manager. By working together, you can design an investment program geared toward your objectives, and adjust the plan when necessary to adapt to shifts in market conditions and your changing needs. These continuing efforts will put you in a better position to achieve your financial goals.

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