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

THOUGHT LEADERSHIP PERSPECTIVES

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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 cannot maintain positions through all phases of a market cycle.

The fourth quarter of 2018, the early part of 2020, and year to date 2022 have all reminded investors how unpleasant market volatility (significant declines) can feel, and provided investors an opportunity to re-evaluate their portfolios in light of that 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 these recent declines 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 OVER THE PAST SEVERAL YEARS 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.

2022 has provided a fitting example of how diversification can benefit investors. Through the first three quarters of this year, both of the major traditional asset classes, fixed income and equities, have suffered significant declines (over 15% and 24% respectively using common indices). Fortunately, some alternative assets (a wide-ranging category that includes investments such as private assets, hedge funds, inflation fighting assets, and managed futures) have provided a significant buffer to the losses in fixed income and equity. Several sub-categories of alternatives are up double digits during the first three quarters of 2022, which has helped some alternative portfolios achieve results of plus or minus a few percent. While that is not going to excite most investors in a better investment environment, it has been beneficial this year in terms of reducing overall portfolio losses and particularly allowing investors that need cash from their portfolios to not be forced to sell equity or fixed income when they are down significantly. As a note, many alternatives reduced portfolio performance during the equity bull market (there is no investment that is great all the time), but we believe that portfolio diversification leads to better long-term risk adjusted performance and a smoother ride for investors.

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 client 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 US.

ABOUT FAIRMAN GROUP FAMILY OFFICE

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