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Harris provides flexibility and a broad spectrum of choices, offering everything you need to create financial strategies that work for you now and at every stage of your life. Our team-based approach enables you to move confidently and easily among different types of services and levels of advice.

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The Power of Asset Allocation:

Maximizing Returns in a Complex Investment Environment

By Jack Ablin, CFA
Chief Investment Officer
Harris

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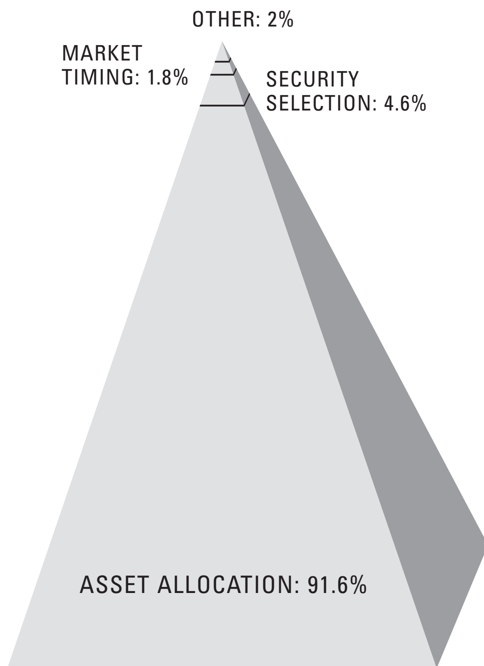
"...The asset allocation decision is by far the most important made by the investor."

–William Sharpe, Nobel Laureate

We hear about it every day. It's on the news, in newspaper and magazine headlines, even joked about in television commercials. Investors spend a great deal of time trying to get it right. What then, exactly, is asset allocation? How does it make a difference in an investor's current and future performance returns? What are some tried and true strategies of asset allocation? And finally, how does an investor measure the success of asset allocation over time?

What is Asset Allocation?

In the simplest terms, asset allocation refers to how one's assets are invested among the various asset classes (stocks, bonds, cash, real estate etc.). The goal of asset allocation is not to achieve the highest possible return but to maximize return for a chosen expected level of risk.



Source: "Determinants of Portfolio Performance," Brinson, Hood and Beebower Financial Analysts Journal

By selecting assets that do not move in tandem, portfolio risk is reduced.

The Power of Asset Allocation in Portfolio Returns

Asset allocation, the process of selecting the appropriate mix of stocks, bonds and cash, explains more than 90 percent of the return investors earn. Yet, in spite of its importance in determining investment success or failure, many investors do not effectively diversify their assets. Because no investor can accurately predict the best performing asset class this year or any future year, asset allocation plays an important role for all investors.

Stocks, bonds and cash each have their own separate risk levels and return expectations. When creating a portfolio of stocks, bonds and cash, the investor may have a greater risk/return profile compared to that of a portfolio comprised of one class used independently.

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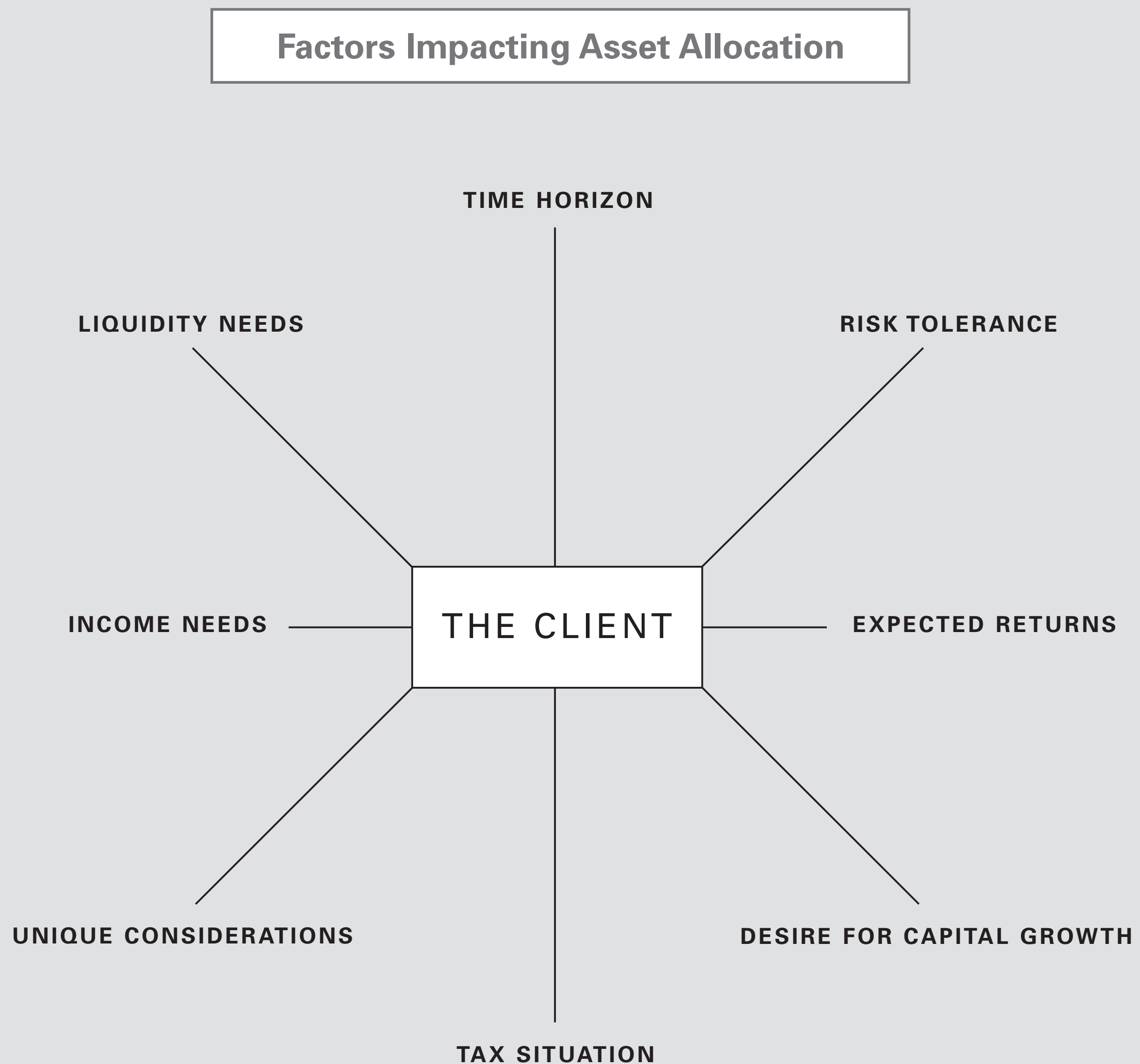
Determining the Appropriate Asset Allocation Strategy

Understanding one's risk tolerance is key to determining an appropriate asset allocation strategy. Having experienced steadily declining stock prices over the last few years, investors have learned the risk lesson well. If it has not been done already, investors should re-evaluate their portfolios to determine their consistency with chosen risk levels.



Factors Impacting Asset Allocation

- **Investment Goals and Objectives**
  Whether investors are interested in accumulating, growing or preserving family wealth, understanding their goals and objectives is the cornerstone of constructing a portfolio based on appropriate asset allocation. Goals such as college planning, preparing for retirement or building a home, need to be identified and prioritized.

- **Time Horizon**
  Time horizon is probably the single most important factor in determining the appropriate level of a class of securities in the overall asset allocation. For example, over the long term, stocks have provided investors with superior returns. As an investor's time horizon extends, a higher proportion of equities should be employed in the portfolio.

- **Liquidity Needs**
  Liquidity needs are often associated with time horizon. Portfolio liquidity provides investors with readily available cash. Liquidity, however, can be expensive, as it requires a higher allocation to lower-returning cash reserves and/or short-term bonds.

- **Income Needs**
  Many investors utilize their investment portfolios to provide them with regular income. Fixed-income securities, or bonds, can often be employed to match portfolio investments with income requirements.

- **Unique Considerations**
  Because every investor is different, special considerations should not be overlooked when constructing an asset allocation. For example, an investor may hold a large concentration in a single stock, significant real estate holdings, or may own substantial private real estate; these factors will, in part, determine the overall asset allocation strategy.

- **Risk Tolerance**
  Risk and potential return are closely related. Each investor must weigh their ability to accept increased risk to reap potentially higher returns.

- **Expected Returns**
  Historical averages of different asset classes are useful to determine the reasonable expected returns over full investment cycles.

- **Desire for Capital Growth**
  Investors desiring high capital growth should have a greater allocation in equities. Historical data has shown that over long periods, the return on stocks has exceeded the return on bonds.

- **Tax Situation**
  The tax profile of an investor or an investment account does not necessarily alter the appropriate asset mix. The tax situation, however, may determine the type of bonds or equity strategy that should be employed.

Past performance is no guarantee of future results.

Asset Allocation and Risk Management

Effective asset allocation strategies combine the needs and objectives of the investor with the investment manager's evaluation of the capital markets. Risk management, the maximization of investment return at a chosen level of expected risk, is the key to successful investing. Although risk can never be eliminated, portfolio construction utilizing careful asset allocation can minimize risk factors and help the investor to meet expectations.

Risk, as perceived by investment clients, takes several forms:

- **Market Risk**. Market influences affect the return of equities or fixed-income securities in ways that cannot be anticipated. The thought of an investment losing money as a result of a market decline is unpleasant at best. Investors primarily concerned with principal protection are unwilling to tolerate a principal loss over any investment time horizon.
- **Interest Rate Risk.** This risk refers to the fact that investment returns may be better or worse than anticipated because of changes in the level of interest rates. Investors with specific cash level targets run the risk of not achieving their goals. For example, parents anticipating a college tuition payment may wish to pursue an investment strategy designed to reach a specific dollar target by a particular date; however, their investment may have lost value with changes in interest rates.
- **Inflation Risk**. In seeking a positive real rate of return, purchasing power is a major concern of investors. Inflation is the steady erosion of an investor's money value over time; the amount of erosion will depend on the inflation rate. In order to maintain purchasing power, investors typically wish to maintain an investment growth rate in excess of the inflation rate.
- **Liquidity Risk**. Unexpected cash needs are a concern for investors. The ability to turn an investment into ready cash is a feature many investors desire. An investment with a lower level of liquidity should offer a higher equivalent return.

Asset Allocation Strategies for Long Term Investing

At Harris, we use five general asset allocation strategies, each designed to help the investor maximize investment returns for a given level of risk tolerance. Every investor knows that there is a risk-return tradeoff; in order to obtain greater returns on investments, the investor must be willing to take on greater risk.

The optimal set of investments within a portfolio that generates the highest return for any given level of risk is called the "efficient frontier." Investors typically prefer to invest in an efficient portfolio; that is, a portfolio for which there are no others that offer a greater return for a particular level of risk.

The following profiles correspond to five investment strategies.

These strategies focus on the long-term. The portfolio risk declines as the time horizon lengthens: that is, over the long run, market volatility becomes a less significant factor.

- **Maximum Growth**
  This investment strategy seeks to provide above-average returns by fully investing in equity securities. No more than 10% of the portfolio should be devoted to fixed-income assets. This strategy employs investments in both domestic and international companies. This strategy is designed for investors whose regular income is generated outside their portfolio. This category of investor typically has no need for current portfolio income, has a long-term investment horizon, and has the resources to withstand the volatility inherent in equity investing.

- **Capital Growth**
  This investment strategy seeks to provide a blend of portfolio appreciation and modest current income by investing in equity and fixed-income securities. This strategy is designed for investors with little need for current portfolio income and a relatively long-term investment time horizon as well as the resources to withstand market volatility.

- **Balanced**
  This investment strategy seeks to provide a balanced allocation between equity and fixed-income securities. This strategy is designed for investors with a need for both portfolio appreciation and current income. Investors should have an adequately long-term investment time horizon and sufficient resources to withstand market volatility.

- **Current Income**
  This investment strategy seeks to provide a blend of current income and modest portfolio appreciation by investing in fixed-income and equity securities. This strategy is designed for investors with a higher need for current portfolio income as well as some desire to participate in equity appreciation.

- **Capital Preservation**
  This investment strategy seeks to provide principal protection by investing in fixed-income securities. No more than 10% of the portfolio should be allocated to equity securities. This strategy is designed for investors with little or no tolerance for principal volatility. This strategy is designed for the investor who is willing to accept lower returns in exchange for increased stability.

Asset Allocation and Your Financial Plan

Financial planning, the process of plotting your financial road map, is an important first step in developing an investment program. It is recommended that a trained financial planner make a thorough assessment of an investor's needs and objectives as well as assets, liabilities, income and spending requirements. The planner will then integrate this data into financial projections, and, with the assistance of an investment manager, make reasonable assumptions about the future purchasing power and financial-asset growth rates of various asset classes. Once a financial plan is established, the appropriate asset allocation is implemented in accordance with the client's long-term goals.

The financial plan summarizes short, intermediate and long-term financial goals, and is dynamic. As life changes, so do financial plans and investment strategies, which should be reviewed at least annually.

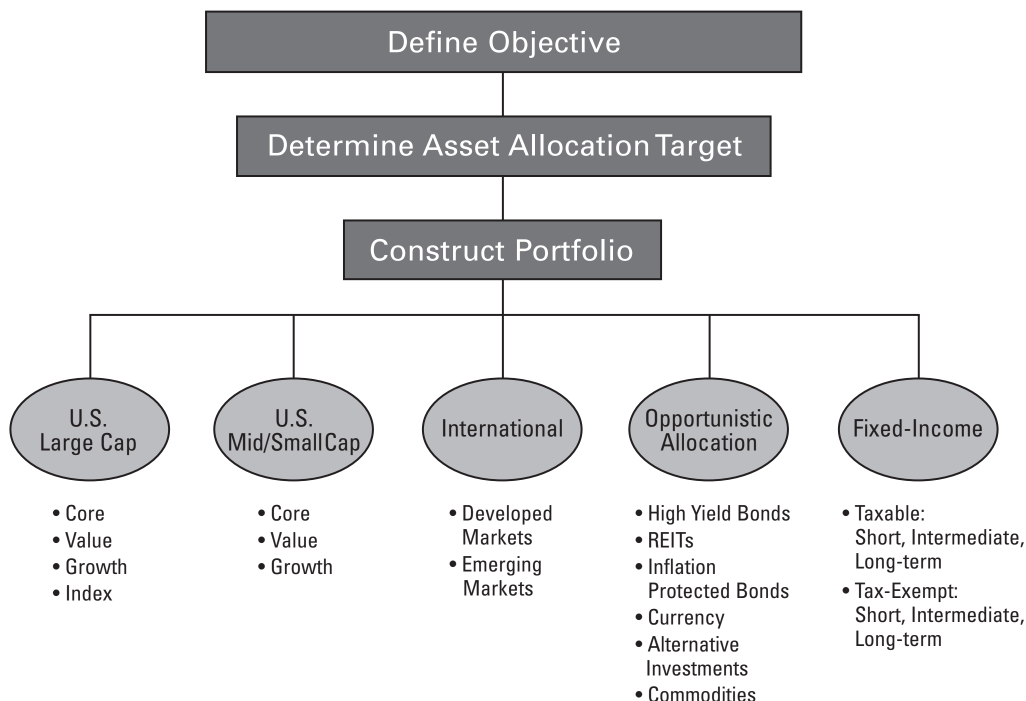
Asset Allocation and Your Estate Plan

Once an investor has an established financial plan, the resulting recommendations may necessitate the development of a customized estate plan. An estate plan can address a number of concerns including:

- the distribution of your estate;
- estate administration;
- charitable giving; and,
- minimization of estate tax.

Practically speaking, an estate plan allows the investor to efficiently transfer wealth to a spouse, a parent, heirs, charities, and/or to provide education for children or grandchildren. Because all assets must be considered in the asset allocation process, this step is crucial. Estate planning can be complicated, so it is best to work with a professional, especially if the estate grows and becomes more complex. A comprehensive, effective estate plan will serve several generations, and if designed and executed properly, may minimize an investor's estate tax.

Investment Process



Unique Considerations and Strategies for Concentrated Investments

Low-cost Basis and Concentrated Positions
Often high-net-worth clients are faced with the complication of an extremely large exposure to a single stock. Concentrated positions in low-cost basis stock are particularly challenging in an environment where diversification is a proven risk-reduction tool. There are several strategies that may be employed to attenuate the risk of a single-stock position while respecting the need to avoid capital gains tax.

Low-cost collar
Using exchange-traded put and call options, a hedge that sells a portion of future upside benefit in exchange for future downside protection can be a cost-effective way to dampen the volatility of a single stock position without selling the security and incurring a capital gain.

Exchange Fund
This diversification strategy is designed to avoid capital gains tax. Exchange funds allow investors to exchange their exposure in their single-stock for participation in a diversified portfolio without triggering a taxable event. The "exchange" is a private partnership of individual subscribers each of whom hold a different concentrated stock position. New partners are accepted or rejected based upon the shares they offer and their consistency with the fund's overall investment strategy. Once accepted, each partner is given an "Inspection Report" in order to review the potential portfolio. All accepted investors are allowed to examine the inspection report prior to making their final investment decision.

Covered Call Writing
This income-oriented strategy sells a portion of future upside potential in exchange for a premium, or fee, received today. This allows for diversification as the underlying security is "called away" in the future.

Selling Forward
Holders of a large stock position may engage in a forward sale. This obligates the holder to sell a portion or their entire position in the future. This strategy offers a future value while actually not creating a sale for tax purposes until the actual exchange of the security is consummated.

Active Asset Allocation

Active asset allocation is the process of identifying overvalued or undervalued asset classes and increasing or decreasing their respective weightings within an investor's long-term strategic allocation. This is an effective way to add substantial value over a one to two-year investment horizon.

Harris recognizes the benefit of active allocation to clients and has devoted significant time and resources to the task of evaluating asset classes and sub-asset categories. We evaluate traditional asset classes like large and small capitalization stocks as well as non-traditional asset classes like real estate, high-yield bonds and emerging market stocks. In spite of the enormous opportunity to add value, few investment management firms devote sufficient time and resources to this endeavor.

Active allocation, if executed properly, can add substantial value over time. While the purpose of strategic allocation is to minimize risk using historical relationships, the purpose of active allocation is to add return by using forecasts of relative returns.

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The Dynamic Process of Investing

Your life changes and so should your investment portfolio. If you are investing on your own, it is important to look at your overall financial picture, at least annually. Portfolio rebalancing, as well as investing in general, takes discipline, requiring investors to sell securities that have performed well and buy securities that have underperformed.

Before you make any adjustments in your portfolio, review the costs associated with the sale. Be sure to understand what commissions, sales charges and redemption fees may be associated with the sale. In addition, you should consider the capital gain and loss implications related to your particular tax situation.

The investment process is dynamic and should be flexible enough to adapt to virtually any life change. Client objectives change over time and, as we all know, the investment markets are continually changing. Consider the professional resources available to you. Have an ongoing dialogue with a relationship manager or advisor to track the progress of your investment program. You can also benefit from receiving quarterly investment reports that summarize asset allocation and provide detailed performance reporting. Whether you use a manager or manage on your own, ensure that your investment program is reviewed periodically for consistency with your objectives.

Jack Ablin, CFA, is Senior Vice President and Chief Investment Officer with Harris Private Bank. He is responsible for establishing investment policy and strategy within the Personal Investment Management Group of the Private Bank. Mr. Ablin also serves on the Asset Allocation Committee, which determines the strategy for investment portfolios for Harris Private Bank. Mr. Ablin joined Harris in 2001 and has more than 20 years of experience in financial services.

Mr. Ablin earned a bachelor's degree from Vassar College, New York, where he graduated with honors with an AB in mathematics and computer science. Mr. Ablin received an MBA with honors and graduated cum laude from Boston University and is a member of the Beta Kappa Sigma honors society. He holds the Chartered Financial Analyst (CFA) designation.

Mr. Ablin makes his home in Chicago, where he is a member of the CFA Institute and the Chicago Financial Analysts Society. He appears frequently as a guest commentator on CNBC.

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