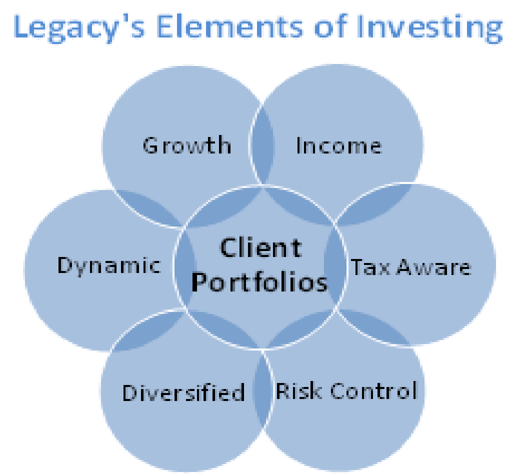
LEGACY WEALTH ADVISORS

Asset Allocation Primer

Volume IV, 2017

There are a lot of different factors that influence individual investors when making decisions on what to buy, when to buy and sell it, and how much to own. As a result, there are a lot of different ways to make, and unfortunately lose, money when investing in financial markets. Often associated with the latter are such time-honored favorites as "chasing momentum", "buying the dips", buying the hot IPO, "chasing yield", "Dogs of the Dow", hiding in "safe" dividend stocks, and putting all one's eggs in one basket (AMZN, APPL, SNAP, etc.)

This month we take a deeper look at one of the most important aspects of investing by examining the critical importance of proper Asset Allocation, both tactically and strategically, in achieving long term success.



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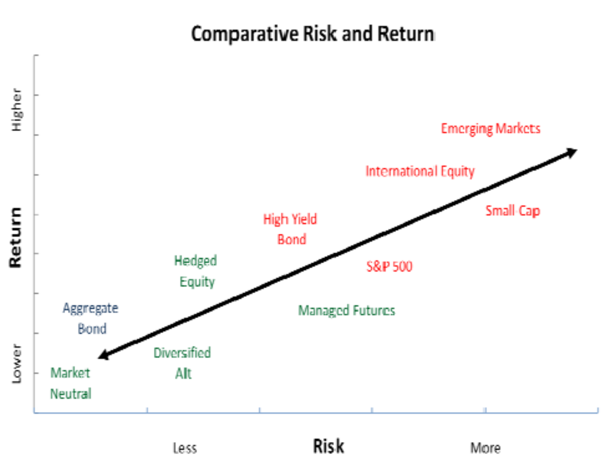
Risk and Reward

We begin with a discussion of the rationale for, and expected benefits of, asset allocation and how individual components of AA work together to reduce risk, enhance returns and minimize taxes. It is axiomatic that investors want to be compensated for the risk of providing funds for various types of investments; whether that risk is the potential for absolute loss of capital, its diminishment by the effects of inflation, the opportunity cost of owning a lesser investment, or the "loss" of peace that comes with too much volatility. Also, investors typically have varying degrees of risk perception, acceptable levels of volatility, and expected or desired investment returns, so the comments below will necessarily be more general in nature, but will address each factor in turn.



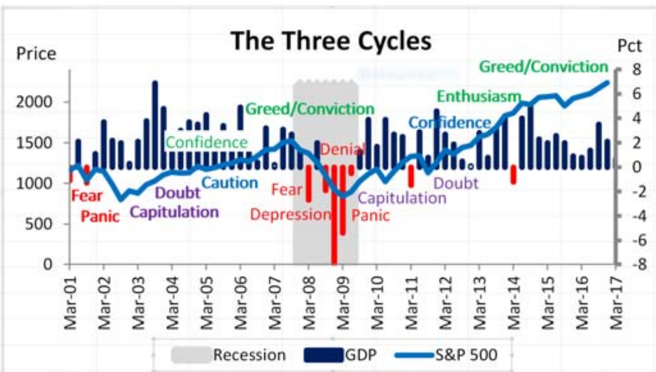
For simplicity sake we will utilize an accepted industry measurement known as *Standard Deviation of Returns* to display the level of volatility (the magnitude of price swings, over time) when discussing various asset classes and segments. By measuring historical patterns of returns, both positive and negative, across varying lengths of time, we can develop a picture of the average volatility of returns for each class, as measured against its long term average returns. This examination reveals a historical pattern that supports the notion that investors typically expect and demand a higher return on investments with a greater level of volatility, and a higher risk of loss.

We can see from the chart to the left that there is a strong relationship between risk (volatility) and expected returns as demonstrated by standard asset class and specific sector profiles. For example, bond returns are typically much lower than stocks over time but have a commensurately lower level of volatility. Emerging markets and small company stocks are notorious for their higher volatility levels and greater magnitudes of loss in down markets, but compensate investors with higher average long term returns.

Asset Allocation is the process of selecting which asset classes to own at what time, and in what proportions, to influence and better manage the overall degree of volatility one is willing to experience over a full market cycle in order to achieve a certain level of expected long term returns.

Economics, Emotions and Markets

We have written in the past about the relationships between the economy, the markets and investor psychology, and how there are leads and lags in the relationships between the three. All three are historically cyclical in nature, and go through relatively predictable stages for each cycle. At the most basic level, economic growth drives perceptions of earnings prospects for businesses, which helps drive market valuations for securities, as well as consumer confidence, or lack there of, in both. The relative predictability of each of these cycles, if not the timing, should help inform both strategic and shorter tactical asset allocation decisions.



Economies routinely move from boom to bust; cycling from economic slowdowns or outright recession to business recovery, expansion, overheating, excess capacity and tight labor markets, with higher costs leading to a lessening of profitability, followed by an expense tightening phase, with perhaps layoffs and business closures leading to recession again. The chart above tracks quarterly US GDP along with the S&P 500's performance as it emerged from the 2000-2001 recession through the subsequent recovery and into the recession of 2008, and its recovery.

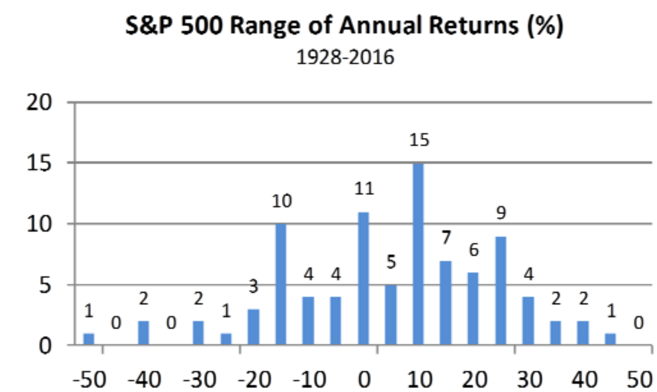
It clearly demonstrates that markets reflect, and routinely anticipate shifts in the economy and business profitability, as investors work through their own emotional cycle, from doom to exhilaration and back. These shifts in investor sentiment and confidence in the economy, and by extension the markets, are securities prices. While GDP growth, business sales, earnings and profits reflect current conditions, investors are typically more concerned with future prospects in determining how to position their investments. As a result we typically see markets turn up before economic growth turns positive after a recession, and turn down several quarters before the first negative GDP report .

We also note how investor aversion to volatility and capital loss is most severe as economic and market bottoms are approached. Conversely, the temptation to be the most bullish typically is seen right at the peak of the stock market's cycle, when the economy is strong, and sales, earnings and profits are near their highest. As a result, market peaks and troughs are typically the most dangerous times for most investors. Greed and Fear always drive investors; and usually in the wrong direction at the wrong time.

Common Questions

One commonly asked question is as follows: *"Since we know the economy and markets are cyclical in nature why don't we just buy at the bottom and sell at the top, and avoid all the downside"?* It's an easy question with a difficult answer.

While it is easy to identify the peaks and troughs of economic activity and markets with benefit of hindsight and a well constructed chart, it's quite another thing to do it in real time. Most of the national level economic data is reported based upon initial estimates and sampling of economic activity, and can change significantly as subsequent revisions gain greater detail and breadth of reporting sources. The National Bureau of Economic Research (NBER) is responsible for determining when recessions occur and assigning their specific beginning and ending dates based upon an examination of specific factors and threshold levels of measurement. Unfortunately, due to the many data revisions over many months of gathering and analyzing the data, the dating process is far from timely. The actual declaration that a recession has occurred may even be made after the recession has ended and the recovery is underway. As a result, using reported economic data to "time the markets" is far more difficult to do in practice than in theory.



A second question is: *"Given their long term superior performance, why not just buy stocks and be done with it?"*

While most investors profess to having a long term investment horizon, they also have a maximum pain threshold for loss, above which they are inclined to sell an asset or portfolio. Despite an attractive long term average return, the chart above shows the significant variation and magnitude of S&P 500 annual returns since 1928, including a large number of significant annual losses. What is not shown is the existence of some significantly higher multi-year losses, which have historically tested investors' resolve to remain fully invested.

Because of their inherent aversion to loss, it can be difficult for most investors to "stay the course" when confronted by significant or multi-year losses. Our preferred solution is to utilize tactical as well as longer-term strategic asset allocation to construct durable, opportunistic portfolios designed to increase chances for enhanced returns and controlled risk across a full investment cycle.

Dynamic Asset Allocation

We have shown that attempts to "time the markets" based upon economic data and business cycles have historically proven difficult to do in a repeatable manner. We have also seen that accepting high concentrations in single-class assets, no matter how attractive their long-term average returns may be, increases the risk of unacceptable losses when investors succumb to the pressure to sell at their point of maximum pain in difficult markets. The challenge then becomes one of capturing as much of the upside economic and market cycle performance as possible, while limiting volatility and risks to acceptable levels on selloffs.

We can largely reconcile these two competing goals by taking advantage of another well known market phenomenon; that expected and realized returns to different asset classes and sectors have not generally been well correlated over time and are largely unpredictable on a year-to-year basis. In other words, individual sectors have not performed in a uniform and monolithic manner across a full economic and market cycle. This is important because it removes the requirement to determine exactly where one is in an economic cycle in order to be a successful investor. Understanding the historical relationship between market cycles and segment performance may enhance the probability of successful outcomes.

Astute investors can take advantage of these differences by recognizing that individual assets tend to react differently to given levels of economic strength, inflation rates, interest rates, strength of the U. S. Dollar, employment levels, corporate profitability, and valuations among many other factors affecting markets at any given point in time.

Taking advantage of this tendency also helps remove the incentive to try and guess the market's tops and bottoms in order to jump into, and out of, the market or specific segments. In fact, we will demonstrate on the following pages that establishing a well diversified portfolio including multiple asset classes (some complementary and some competing) can go a long way in reducing overall portfolio volatility, smoothing long term returns, and calming investors.

One of our favorite charts is the "Bingo" chart, shown below, which illustrates that differing asset classes traverse the range from "best" to "worst" across a market cycle, and sometimes even within a single year. For example, *Emerging Markets*, which dominated performance from 2003-2007, was down an astounding -53% in 2008, followed by a stellar 79% rebound in 2009, and has delivered a mixed, though uninspiring performance over the last 6 years. Most of the elements on the table have similar periods of apparently random strength and weakness, which would render an "all-or-none" approach to including individual classes in a portfolio virtually impossible to execute successfully.

However, we acknowledge that some classes have historically done better (or worse) depending upon stage of the economic or market cycle, so it makes little sense to hold an equal weighted position in all sectors, at all times. We have found that it is a more effective approach to dynamically over and under weight various asset classes and sectors depending upon the current and expected economic outlook, market conditions and valuations, rather than taking an "all-or-none" positioning stance for a given sector, or attempting to "time the market" by raising significant levels of cash.

Relative Asset Class Performance

2002 – 2016

Goldman Sachs Asset Management

Bank Loans · Commodities · Emerging Market Debt · Emerging Market Equity · Hedge Funds · High Yield · International Equity · International Real Estate · International Small Cap · US Aggregate Bonds · US Large Cap · US Real Estate · US Small Cap

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Best Performance	Commodities 32.1%	Emerging Market Equity 56.3%	International Real Estate 41.0%	Emerging Market Equity 34.5%	International Real Estate 43.9%	Emerging Market Equity 39.8%	US Aggregate Bonds 5.2%	Emerging Market Equity 79.0%	US Real Estate 28.5%	US Real Estate 8.9%	International Real Estate 38.5%	US Small Cap 38.8%	US Real Estate 31.9%	International Small Cap 5.9%	US Small Cap 21.3%
	Emerging Market Debt 13.7%	International Small Cap 49.5%	US Real Estate 34.8%	Commodities 25.6%	US Real Estate 35.7%	Commodities 32.7%	Emerging Market Debt -12.0%	High Yield 59.4%	US Small Cap 26.9%	US Aggregate Bonds 7.8%	High Yield 19.6%	US Large Cap 32.4%	US Large Cap 13.7%	US Real Estate 4.5%	High Yield 14.3%
	US Aggregate Bonds 10.3%	US Small Cap 47.3%	Emerging Market Equity 16.0%	International Small Cap 19.4%	Emerging Market Equity 32.6%	International Equity 11.2%	Hedge Funds -21.4%	Bank Loans 44.9%	International Small Cap 21.6%	Emerging Market Debt 7.3%	Emerging Market Equity 18.6%	International Small Cap 25.8%	Emerging Market Debt 7.4%	US Large Cap 1.4%	US Large Cap 12.0%
	High Yield 4.1%	International Real Estate 45.8%	International Small Cap 25.8%	International Real Estate 17.3%	International Small Cap 26.8%	Hedge Funds 10.3%	High Yield -26.9%	International Small Cap 44.2%	Emerging Market Equity 19.2%	High Yield 3.1%	International Small Cap 18.4%	International Equity 22.8%	US Aggregate Bonds 6.0%	Emerging Market Debt 1.2%	Emerging Market Equity 11.6%
	US Real Estate 2.7%	International Equity 38.6%	International Equity 20.2%	US Real Estate 13.8%	International Equity 26.3%	US Aggregate Bonds 7.0%	Bank Loans -28.8%	International Real Estate 42.8%	International Real Estate 18.1%	US Large Cap 2.1%	Emerging Market Debt 17.4%	Hedge Funds 9.0%	US Small Cap 4.9%	US Aggregate Bonds 0.5%	Commodities 11.4%
	International Real Estate 1.7%	US Real Estate 37.1%	US Small Cap 18.3%	International Equity 13.5%	US Small Cap 18.4%	Emerging Market Debt 6.2%	US Small Cap -33.8%	International Equity 31.8%	US Large Cap 15.1%	Bank Loans 1.8%	International Equity 17.3%	International Real Estate 8.3%	International Real Estate 3.9%	Hedge Funds -0.3%	Emerging Market Debt 10.2%
	Bank Loans 1.1%	High Yield 32.4%	Commodities 17.3%	Emerging Market Debt 10.2%	US Large Cap 15.8%	US Large Cap 5.5%	US Large Cap -37.0%	Emerging Market Debt 29.8%	High Yield 14.8%	Commodities -1.2%	US Real Estate 17.1%	High Yield 7.3%	Hedge Funds 3.4%	Bank Loans -0.4%	Bank Loans 9.9%
	Hedge Funds 1.0%	US Large Cap 28.7%	High Yield 13.2%	Hedge Funds 7.5%	High Yield 13.7%	International Small Cap 5.1%	US Real Estate -39.8%	US Real Estate 29.0%	Emerging Market Debt 12.2%	US Small Cap -4.2%	US Small Cap 16.4%	Bank Loans 6.2%	Bank Loans 2.1%	International Real Estate -0.7%	US Real Estate 6.6%
0%	Emerging Market Equity -6.0%	Emerging Market Debt 22.2%	Emerging Market Debt 11.6%	Bank Loans 5.7%	Hedge Funds 10.4%	High Yield 3.2%	International Equity -43.4%	US Small Cap 27.2%	Bank Loans 10.0%	Hedge Funds -5.7%	US Large Cap 16.0%	US Real Estate 1.3%	High Yield 0.0%	International Equity -0.8%	International Small Cap 3.6%
	International Small Cap -9.4%	Commodities 20.7%	US Large Cap 10.9%	US Large Cap 4.9%	Emerging Market Debt 9.9%	Bank Loans 1.9%	Commodities -46.5%	US Large Cap 26.5%	Commodities 9.0%	International Equity -12.1%	Bank Loans 9.4%	Commodities -1.2%	Emerging Market Equity -1.8%	High Yield -2.7%	US Aggregate Bonds 2.6%
	International Equity -15.9%	Hedge Funds 11.6%	Hedge Funds 6.9%	US Small Cap 4.6%	Bank Loans 7.3%	International Real Estate -1.6%	International Small Cap -46.8%	Commodities 13.5%	International Equity 7.8%	International Small Cap -14.1%	Hedge Funds 4.8%	US Aggregate Bonds -2.0%	International Small Cap -3.2%	US Small Cap -4.4%	International Real Estate 2.2%
	US Small Cap -20.5%	Bank Loans 11.0%	Bank Loans 5.6%	High Yield 3.6%	US Aggregate Bonds 4.3%	US Small Cap -1.6%	International Real Estate -51.8%	Hedge Funds 11.5%	US Aggregate Bonds 6.5%	International Real Estate -14.7%	US Aggregate Bonds 4.2%	Emerging Market Equity -2.3%	International Equity -4.9%	Emerging Market Equity -14.6%	International Equity 1.0%
Worst Performance	US Large Cap -22.1%	US Aggregate Bonds 4.1%	US Aggregate Bonds 4.3%	US Aggregate Bonds 2.4%	Commodities -15.1%	US Real Estate -17.7%	Emerging Market Equity -53.2%	US Aggregate Bonds 5.9%	Hedge Funds 5.7%	Emerging Market Equity -18.2%	Commodities 0.1%	Emerging Market Debt -5.3%	Commodities -33.1%	Commodities -32.9%	Hedge Funds 0.5%

Markets are notoriously difficult to time, as demonstrated by the varying asset class returns above. Diversifying asset class exposures may help investors sidestep this problem and improve the likelihood of achieving their investment goals.

Source: GSAM, as of December 31, 2016. This example is for illustrative purposes only. **Past performance does not guarantee future results, which may vary.** Diversification does not protect an investor from market risks and does not ensure a profit. 1

The Legacy Approach

Where does all this theory leave us? At Legacy, we believe that asset allocation decisions should begin with a thorough understanding of the specific and unique objectives for each client. We work with our clients at the outset of the relationship to uncover short and long term cash flow requirements, understand the totality of each client's business interests and other liquid and illiquid assets, and uncover long term legacy and philanthropic intentions so that we may fully understand the return expectation and risk tolerance for portfolios we invest. Our approach is to advise clients to select asset allocations that will expose their portfolios to the least amount of risk necessary to allow them to meet their objectives. We accomplish this by building portfolios which have the best probability of delivering long-term risk adjusted returns in line with client expectations. We strive to enhance portfolio performance by using our experience to tactically adjust portfolios to take advantage of shorter-term opportunistic investment opportunities.

In short, we believe that establishing the proper long-term, strategic asset allocation mix is the single most important thing we can do for our clients. By adjusting each underlying account's asset mix to the client's risk profile for each particular subset of their investable assets, we can better manage the overall portfolio's expected volatility and targeted returns, reduce the tax impact from trading decisions, and potentially allow the client to have less anxiety, and a better sense of resolve to "stay the course" when markets get difficult.

We take advantage of both internal and external resources to help identify and evaluate shorter-term global market dislocations, and utilize dynamic asset allocation shifts to take advantage of them. We also seek non-traditional sources of income (such as *Structured Products*, and *Reverse Convertible Notes*) in special situations,

Source: HFRI, Morningstar

which may have an expected time horizon of several months to as much as a year. These are implemented across individual portfolios based upon their individual, unique profiles.

For example, we have been tactically underweight in both *Developed International* and *Emerging Markets* for several years due to our evaluation of economic, political and valuation issues in those markets. The chart above reveals the decision has been a solid one, with both segments delivering historically low average investment returns, relative to their higher risk levels. We have also maintained a fully-allocated position in *Bonds* (including *High Yield*) despite a multi-year consensus recommendation to underweight them, as well as a bias for domestic large cap stocks, such as the S&P 500.

By establishing a dynamic, fully diversified portfolio, including alternative assets such as *Diversified Alternatives* and *Hedged Equity* (see 40/40/20 above) we have been able to increase our average returns as well as substantially reduce our overall portfolio volatility over the last five years, relative to a traditional 60/40, stock/bond portfolio. We find that flexibility in investing is a key element of success in helping investors reach their long term investment goals with less anxiety and smoother returns.

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Now What?

We have remained mildly cautious on the broader equity markets even as they have continued to move higher this year. Our perception of market risks remain elevated and we maintain our underweight positions in small caps, international and emerging market equities. We maintain our positions in high quality, medium duration bonds, but would begin to lower weightings to longer duration high yield bonds and interest rate sensitive securities as the Fed gets more aggressive on rates.

U.S. equities and bonds have continued to provide a better risk/return profile than many overseas markets, but the valuation disparities in Developed International and Emerging Markets are starting to prove interesting. We continue to actively monitor these sectors.

If you would like more information, please contact us.

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