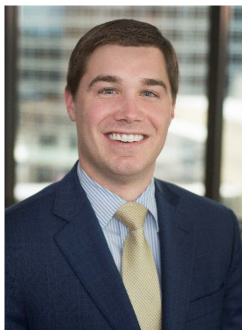
Legacy Trust

Investment Perspectives

Asset Allocation Check-Up

June 2020



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Key Takeaways

- Strategic long-term asset allocation plans are the key driver of portfolio performance
- The allocation plan is set based on fundamental considerations like time horizon, liquidity needs, and taxes
- An investor's risk tolerance is an important influence on the investment plan but is subject to change based on the market environment
- Setting the allocation plan in writing during times of market calm helps investors stay the course during bouts of volatility

The asset allocation an investor chooses is one of the most important decisions they will make when building out their investment portfolio. Asset allocation is defined as an investment strategy that aims to balance risk and reward by apportioning a portfolio's assets according to an individual's goals and objectives.

The asset allocation decision is typically based on a handful of different factors: time horizon for investment, liquidity needs, tax situation and finally, risk tolerance. The resulting portfolio will usually have some blend of equities, fixed income and cash.

- The time horizon for investment is critical because it puts into context how long the portfolio is expected to be invested. For example, the time horizon looks different for a young professional just getting started in their career versus a retired executive in current need of supplemental income.
- Liquidity needs fit right in with time horizon when thinking about what that right asset allocation should be. If we continue the example from earlier, the young professional likely has little to no need for liquidity from their portfolio since they have a stable income stream from work. On the flip side, it is likely that the retired executive will need to draw funds from their portfolio to cover living expenses, medical expenses, and so on. This differing need for funds will also drive the decision of what type of asset mix makes the most sense.
- The investor's tax situation also plays a role, particularly when they may have more than one type of portfolio. Let us consider an investor nearing retirement that has an investment account, a Traditional IRA and a Roth IRA. The overall allocation may be geared towards a balanced-growth portfolio with a mix of 60% equities and 40% fixed income. However, each account could be structured differently to take advantage of the different tax treatments for each account. Bucketing the more growth-oriented assets into the tax-free Roth IRA will allow them to compound without the burden of capital gains taxes, while locating the heavy income-producing assets into the tax-deferred Traditional IRA will avoid recognizing taxable interest and dividends upon receipt. The remaining mix of growth and conservative assets can be placed into the after-tax investment account depending on near-term cash needs, as this will likely be the most advantageous account from which to take withdrawals. This siloed approach within an investor's overall portfolio will put them in the most tax-efficient position to meet their asset allocation targets.
- Risk tolerance can often be the most difficult factor to gauge, because investors have a hard time figuring out how much market volatility they can tolerate until those volatile moments are happening. Behavioral finance studies have shown that an investor's risk tolerance seems to go up and down based on the condition of the market. As investment professionals it is our job to keep our clients focused on the other three factors so that we don't take on significantly more risk or de-risk the portfolio at inopportune times.

The last 18 months or so presents an excellent case study on the benefits of having a defined and well-disciplined asset allocation that considers these four factors. Since the end of 2018 we have seen tremendous moves up in the market, as well as extreme drops down. At the start of 2019, the S&P 500 index began trading at 2,498.94 and by the end of the year was up to 3,230.78, a 31% total increase for the year. Seeing returns at this level made many investors feel great about their financial situation and caused them to forget that the market can in fact move in the other direction.

However, we saw the picture change dramatically the further we went into 2020 as the impact of COVID-19 was felt across the globe. Investors again saw volatility grip their portfolios with the S&P 500 falling from a high point of 3,393.52 on February 19th to a low of 2,191.86 on March 23rd. Needless to say, at the start of the year equity owners could never have fathomed a drop of over 1,200 points in a little over a month. Those same individuals who added to their equity portfolio in 2019 without assessing near-term cash needs or let their weights reach well over target now found themselves in an uncomfortable situation faced with some difficult choices.

This decision of what to do next is one of the most difficult to make as nobody can predict where things will go in the next 30, 60, 90 days and beyond until we have clear indications that the pandemic is ending. Having a well thought out asset allocation is the best way to combat the ebbs and flows of volatility in the stock market. By looking at your time horizon, cash flow needs and general appetite for market risk, you can put yourself in a much better spot for when the momentum of the market is heading the wrong direction. By being able to point to near term cash flow needs or diversifying asset classes within the portfolio which may be holding up much better, you give yourself the chance to take a breath and ride the volatility to the other side.

Source: FactSet Research Systems