The Longer View

COMMENTS AND OUTLOOKS FROM LONGER INVESTMENTS INCORPORATED

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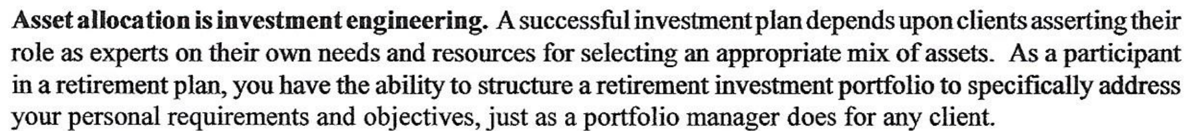
ASSET ALLOCATION



Asset allocation is investment engineering. A successful investment plan depends upon clients asserting their role as experts on their own needs and resources for selecting an appropriate mix of assets. As a participant in a retirement plan, you have the ability to structure a retirement investment portfolio to specifically address your personal requirements and objectives, just as a portfolio manager does for any client.

Asset allocation is the most important decision you face as an investor. Studies in 1986 and 1991 by Gary P. Brinson, et al., published in the Financial Analyst's Journal, demonstrated that over 90% of the return to a portfolio is attributable to the asset allocation strategy. Less than 10% of the variation of returns in an account are due to market timing or the selection of individual securities. The portfolio mix of cash, bonds, and stocks will determine the level of stock market risk, the returns achieved, and the predictability of those returns. A well-balanced portfolio can provide for growth during good markets and preserve capital during negative markets. The asset allocation decision should be based on the considerations of **time horizon, risk tolerance, liquidity needs,** and **investment objective**.

Time Horizon

In arriving at an appropriate asset allocation strategy, the length of time investments will be held and the period of time over which investment results will be measured and judged is the **single most important** consideration. Time horizon is the period that begins when an investment is made and ends when the invested funds are expected to be used. The longer the time period over which investments are held, the closer the actual return in a portfolio will come to the expected average return. The average annual return in the equity market since 1926 has been approximately 10%, however those annual returns have varied widely between a loss of 43% and a gain of 54%.

The chance of a negative return in the stock market over any one-year period is 26%; over a five-year period, 14%; and ten years only 5%. History has demonstrated that as the time horizon lengthens, an investor's chance of losing money in the stock market declines.

Risk Tolerance

Investment returns come in two very different forms. The first is the predictable cash flow received from interest and dividends. The second is the fluctuation in market price that is, in the short run, quite unpredictable. Stock market risk is inherently unavoidable because changes in market prices are caused by changes in the consensus of active investors' opinions of what the prices of stocks should be. Professional investors study monetary and economic conditions, financial reports of companies, analyst research reports, and trade publications. In addition to dealing with information from the rational world, investors also must contend with the less predictable world of "investor psychology," public confidence, market tone, politics, and foreign financial markets. The ways in which investors perceive and interpret information and react to developments have great impact on market prices, particularly in the short run.

Market risk cannot be avoided or eliminated, but the impact of fluctuations in market price on an investment portfolio can be managed. If you are risk averse or if market fluctuations cause anxiety, diversify among other asset categories to match your comfort level. To manage market risk, decide **deliberately** what level of risk to accept in the portfolio's basic policy and hold to that chosen level of risk in good and bad markets. The example in the box on page two illustrates investment returns in rising and declining equity markets with various asset allocation structures.

EXPECTED RANGE OF ONE-YEAR INVESTMENT RETURNS BY ASSET ALLOCATION STRUCTURE

ASSET ALLOCATION STRUCTURE	TOTAL PORTFOLIO RETURN (EQUITIES +40%/YR)*	(EQUITIES -40%/YR)*
100% stocks, 0% bonds	40.0%	-40.0%
80% stocks, 20% bonds	32.6%	-31.4%
60% stocks, 40% bonds	25.2%	-22.8%
40% stocks, 60% bonds	17.8%	-14.2%
20% stocks, 80% bonds	10.4%	-5.6%
0% stocks, 100% bonds	3.0%	3.0%

*BOND RETURN +3.0%/YR.

Risk tolerance is a personal decision and varies widely from one individual to another. Always plan the investment mix from the standpoint of the risk you are willing to tolerate in a poor stock market. By arriving at a mix that is comfortable in a declining market and having the discipline to stay with that mix, you will remain invested for rewarding market periods.

Investment Objective: Income vs. Growth

Interest income returns are more stable than equity returns in the short run but historically have produced less growth of principal over long periods. Equity ownership allows participation in the growth of a company's sales, earnings and dividends. In general, bonds, money market funds, and other fixed-income investments offer income and more stability of principal, without growth.

From 1926-2017, stocks have returned an average annual 10.2% versus 5.5% for bonds and 3.4% for cash. Cash returns have closely tracked inflation rates, which have averaged about 2.9%. Bond returns exhibit more volatility than cash returns because as interest rates rise, bond prices decline and as interest rates fall, bonds increase in value. Returns in the stock market varied between a high of +54% and a low of -43%. The best year in the bond market was +40%, the worst year returned -14.9%. Cash returns ranged between 0% and 14.7%, without negative returns during the 92-year history.

In conclusion, base the asset allocation decision on **time horizon, risk tolerance, liquidity needs,** and **investment objective.** Avoid market timing. Sentiment is always most pessimistic at market bottoms and very optimistic at market tops. If you try to time the market, you risk being out of the market when it turns up or buying into the market just before it peaks.

HISTORICAL INVESTMENT RETURNS

	1926-2017 92 Years	2013-2017 5 Years	Best Year	Worst Year
Stocks	10.2%	15.8%	54.0%	-43.3%
Bonds	5.5%	3.2%	40.4%	-14.9%
Cash	3.4%	0.2%	14.7%	0.0%

Sourcea: 2018 SBBI Yearbook

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