

The Importance of Asset Allocation

How Baird approaches portfolio design

Asset allocation can lead to better overall results, but it needs to be implemented with enough flexibility to adapt to longer-term trends in the market. Here's how Baird approaches this critical aspect of portfolio management.

ASSET ALLOCATION IN AN INTERCONNECTED WORLD

Asset allocation has the potential to increase investment results and lower overall portfolio volatility, but critics argue that the interconnectedness of financial markets lessens the benefits of traditional asset allocation. It is Baird's opinion that both views are correct: Asset allocation can lead to better overall results, but the implementation needs to be flexible enough to adapt to longer-term trends in the market.

WHY ASSET ALLOCATION IS STILL IMPORTANT

Asset allocation is important from a portfolio design standpoint and can also help maintain a long-term perspective and avoid knee jerk reactions.

Portfolio design. The theory asserts that in any given period, some investment styles will be winners and some will be losers, and this will vary over time. The addition of investment styles that perform differently than the rest of your portfolio (i.e., have a low correlation) can reduce overall portfolio volatility. This is because individual asset classes can be volatile, but in a well-constructed portfolio, there will be other investments that partially offset that volatility, both on the upside and downside, thus producing a more stable return pattern.

Long-term perspective. Investors tend to chase the best-performing segments of the market and shun poor-performing areas. This may sound logical, but it is incredibly difficult to guess which areas will *continue* to shine and which lagging areas may develop into leaders around the corner. In fact, trying to time the market can have perverse consequences—as seen in Figure 1.

ASSET ALLOCATION AND DIVERSIFICATION

When determining how to structure a portfolio, it's important to consider two related but separate concepts: asset allocation and diversification. Asset allocation determines how to weight stocks,

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- Why is asset allocation still **one of the most important strategies**?
- How do **asset allocation and diversification** work together?
- How does Baird use asset allocation to create **the best prospects of future success**?

Performance of the Average Investor

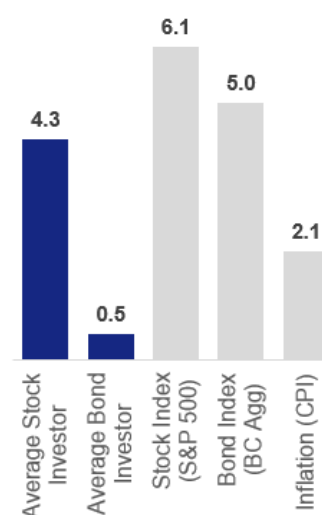


Figure 1. Over the 20-year period ending Dec. 31, 2019, the average investor underperformed the broader markets and failed to keep pace with inflation. Poor investment selection and knee-jerk reactions are key reasons for this. Source: Dalbar (see note on page 5 for more information)

bonds, and cash in a way that provides for the potential for the best return for the risk an investor is willing to take on. Diversification builds on that step by exposing the portfolio to many different areas—to achieve higher returns and lower overall volatility.

Asset allocation. Setting asset allocation targets is a critical first step in portfolio construction. Too much in bonds or cash will ensure lower volatility than stocks but may not produce enough returns to meet investments objectives or keep ahead of inflation. Conversely, too heavy a weighting in stocks can produce higher rates of return over time but can be subject to large swings in value over shorter periods.

Identifying the upside and downside thresholds that an investor is comfortable with is an important step in ensuring that the asset allocation plan has staying power.

Diversification. Diversification spreads assets across investment types and—when done properly—can lead to higher-than-expected returns and lower overall volatility. Diversification works best when asset classes have low correlations with one another—when some zig, the others zag. Historically, this was achieved by simply expanding a large-cap, U.S.-based stock portfolio to include small-cap or international stocks. Over the past 15 years, however, the financial marketplace has become more interconnected and highly correlated. One needs only to look at the dismal 2008 returns of many asset classes to be reminded how similarly different types of investments move in times of turmoil.

Including less commonly used asset classes does not necessarily lead to a diversified portfolio, but Baird believes that asset allocation and diversification strategies need to be flexible and accommodate both traditional and alternative investments.

BAIRD'S APPROACH TO ASSET ALLOCATION

At Baird, a great deal of time and resources are dedicated to the topic of asset allocation as we believe it's an integral part of providing sound advice to our clients. Baird's Investment Policy Committee is charged with the task of preparing model asset allocation portfolios that can be used by a variety of clients. This committee consists of various leaders throughout the organization, with input from the financial planning, research, and asset management departments—as well as our market strategy partners at Strategas (a Baird company). We currently have six models along a continuum of risk and return characteristics (see Figure 4 on the following page)

The committee reviews new investment ideas and makes revisions as needed. Asset allocation is a long-term discipline, but not a set-

Upside and Downside Potential

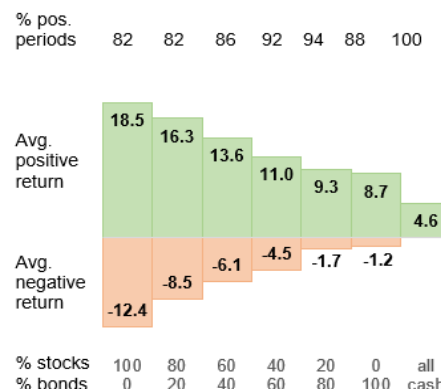


Figure 2. An increased stock allocation leads to the potential for larger positive returns, but also the possibility of larger negative returns. This is shown above in historical averages spanning December 31, 1977 to December 31, 2020. Source: Baird Research, Standard & Poor's, Barclays Capital, Citigroup. See note on page 5 for more information.

Degrees of Asset Allocation

Basic

U.S. Stocks
Treasury
Bonds
Cash

Traditional

U.S. Large-Cap Stocks
U.S. Small-/ Mid-Cap Stocks
International Stocks
Satellite Asset Classes
Growth and Value Styles
U.S. Corporate Bonds
U.S. Municipal Bonds

Expanded

Alternative Mutual Funds
Structured Products
Managed Futures
Hedge Funds
Private Equity

Figure 3. Complexity of asset allocation will vary from investor to investor depending on individual needs and goals.

it-and-forget-it practice. To reflect changes in the market and to capitalize on growing opportunities for “alternative diversification,” the Investment Policy Committee periodically makes more substantive changes to the model portfolios.

Strategic vs. Tactical: It's important to note that the models discussed in this paper are strategic, not tactical. **Strategic models** are meant to take a long-term view of investing, whereas **tactical models** shift allocations based on perceived opportunities in the market. Baird believes the core of a portfolio should adhere to a long-term strategic asset allocation plan with tactical shifts made on a client-by-client basis.

PROJECTING RISK AND RETURN

A well-crafted financial plan plays an important role both before and after an asset allocation model is chosen. First, we use a financial plan to determine what level of projected investment return allows you to meet your lifestyle goals. This can help lead you to the right mix of stocks, bonds and cash. Then we use that financial plan to test drive the model and evaluate the potential outcomes for the chosen mix of assets.

Projecting return for each asset class. The return projections for each asset class are based on a combination of current market data and historical performance, beginning with the current yield on the 10-year U.S. Treasury bond which serves as a baseline, “risk-free” return.

Measuring risk for each asset class. The risk (or volatility) of each asset class is based on long-term historical data. This is called standard deviation. To justify the risks of investing in higher-volatility asset classes like stocks, for example, an investor would expect a return that is greater than what they could earn by investing in (risk-free) U.S. Treasury bonds. The difference between these two returns is called the risk premium. We calculate the expected risk premium for each asset class using historical data in conjunction with future expectations.

Projected return and risk at the portfolio level. For each of our model portfolios, Baird calculates a projected total return for that specific mix of asset classes. The projected total return for each asset class is the projected risk-free return plus the expected risk premium. The volatility of the portfolio is calculated by looking at each asset class's standard deviation as well as correlation assumptions, which are a statistical measure of how asset classes perform in relation to each other based on historical data.

Baird's Strategic Model Portfolios

	Capital Preservation	Conservative Income	Income with Growth	Growth with Income	Capital Growth	All Growth
Large-Cap Value		7	11	15	18	21
Large-Cap Growth		7	11	15	18	21
Mid-Cap Equity		2	6	10	13	15
Small-Cap Equity			2	4	7	9
Internat'l		4	10	16	24	31
Intermed. Fixed Inc.	50	40	30	20	10	
Short-term Fixed Inc.	30	25	15	10	5	
High Yield			5	5	2	
Cash	20	15	10	5	3	3

Figure 4. The asset allocation of Baird's six strategic model portfolios, along a continuum of risk and return characteristics (allocations and weightings are subject to change, numbers from March 2021)

What a financial plan can tell us. Projected portfolio returns are used in the financial plan to determine if the portfolio return will be sufficient to support an investor's goals. If the financial plan projects that the investor's goals would not be met, one solution could be to choose a portfolio with a greater potential return (as opposed to one that altered spending or savings levels or the time horizon). However, the opportunity to achieve a greater investment return over the same period usually requires a portfolio with a higher level of risk.

The opposite can also be true: an investor may have sufficient resources outside their portfolio to accept a lower investment return and still meet their goals. A lower required investment return can generally be accomplished by choosing a more conservative, less volatile profile. A well-built financial plan will evaluate the impact of increasing or decreasing this portfolio risk on the success of the plan. (See the following page for an explanation of Monte Carlo simulations and important disclosures.)

UNDERSTANDING RISK IS KEY

It is important not to focus solely on expected return when using an asset allocation approach to designing a portfolio. Understanding risk—and building flexibility into the portfolio to adapt to long-term market trends—is also key. This combined awareness can make asset allocation a powerful tool to increase investment results and lower overall portfolio risk.

With the right asset allocation tools—carefully researched **model portfolios** and well-crafted, tailored **financial plans**—Baird has the expertise to give clients the best prospects of meeting their financial goals.

NOTES

1. Note for Figure 1, Performance of the Average Investor: Source: Dalbar, Inc. “Quantitative Analysis of Investor Behavior, Advisor Edition.” April 2020. Average equity and bond investor returns are calculated using data from the Investment Company Institute for the 20-year period ending December 31, 2019. The “average” investor refers to the universe of all mutual fund investors whose actions and financial results are restated to represent a single investor. These returns are represented by a change in assets, excluding sales charges, fees, expenses and any other costs. While we believe this information to be accurate, no guarantees can be made to its authenticity or accuracy. The broader stock and bond market are represented by indices. Stocks are represented by the S&P 500 Index and bonds by BbgBarcUS Agg Bond Index rebalanced monthly. Indices are unmanaged and are not available for direct investment. Past performance is not a guarantee of future results

2. Note for Figure 2. Upside and Downside Potential: Source: Baird Research, Standard & Poor’s, Barclays Capital, Citigroup. For December 31, 1977 to December 31, 2020; rolling 12 month performance each six months.

Index definitions: The **S&P 500 Index** is a well-known gauge of stock market movements determined by the weighted capitalization of the 500 leading U.S. common stocks. The **BloombergBarclays Aggregate Bond index** is a broad U.S. bond benchmark composed of Treasury, government-related, corporate and securitized bonds. It includes investment-grade securities that have at least one year to maturity and an outstanding par value of at least \$250 million. These allocations are rebalanced annually. Indices are unmanaged and are not available for direct investment. Past performance is not a guarantee of future results.

DISCLOSURES

All investments carry a level of risk, including loss of principal. Diversification does not ensure a profit or protect against loss.

Monte Carlo simulations are used to show how variations in rates of return each year can affect your results. A Monte Carlo simulation calculates the results of a Plan by running it many times, each time using a different sequence of returns. Some sequences of returns will give better results, and some will give worse results. These multiple trials provide a range of possible results, some successful (you would have met all your goals) and some unsuccessful (you would not have met all your goals). The percentage of trials that were successful is the probability that your Plan, with all its underlying assumptions, could be successful. The Results Using Monte Carlo Simulations indicate the likelihood that an event may occur as well as the likelihood that it may not occur. In analyzing this information, please note that the analysis does not take into account actual market conditions, which may severely affect the outcome of your goals over the long-term. IMPORTANTLY, projections or other information generated by the use of tools designed to test various investment outcomes are hypothetical in nature, can vary with each use and over time, and do not reflect actual investment results and are not guarantees of future results.

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