Despite what you might read in the popular financial media, choosing the best-performing investments does not always translate into success within an investment program designed to meet long-term financial needs and wishes. Unfortunately, many investors rely on shortcuts such as "star" ratings or performance rankings when developing their plans for investing, only to find themselves disappointed in their choices before chasing other "hot" investments. One of the most important investment decisions you can make is to clearly define — and put in writing — your investor profile before starting any investment program. Working with a trusted advisor to define and document your profile and then matching it to an appropriate portfolio of investments properly diversified across a mix of asset classes is the best way to start. The efficient allocation of your investments among various investment asset classes is the first step to achieving your long-term financial objectives. By adopting and documenting an asset allocation that matches your unique profile, you construct a blueprint for your future investment decisions, creating a kind of benchmark or guide that can counter emotional factors like fear and greed.

What is Asset Allocation?

Asset allocation is the process of choosing among possible asset classes in investing. A large part of developing an investment plan consists of finding an asset allocation that is appropriate for you in terms of both your appetite and ability for bearing risk. When performed correctly, the selection and weighting of asset classes will reduce the volatility, or variability of returns, that a portfolio experiences. This is accomplished by diversifying across a variety of investments — such as domestic and international stocks, bonds, real estate securities, and commodities — whose returns do not necessarily move in sync. Asset allocation is effective when the asset classes selected are unlikely to generate similar returns at the same time.

Why is Asset Allocation so Important?

In the 1980s and 1990s, research on the investment strategies of nearly 100 large corporate pension plans was conducted. The famous studies by Gary P. Brinson, Brian D. Singer and Gilbert L. Beebower concluded that the decision of what asset classes to use and in what weighting (asset allocation) was the "overwhelming factor in determining the basic, long-term return achieved per unit of risk (volatility)."* The studies reinforce the assertion that the asset allocation decision has more impact than either the selection of individual securities or the timing of buys and sells.

Other 2.1%

Market timing 1.8%

Security selection 4.6%

Asset allocation decision 91.5%
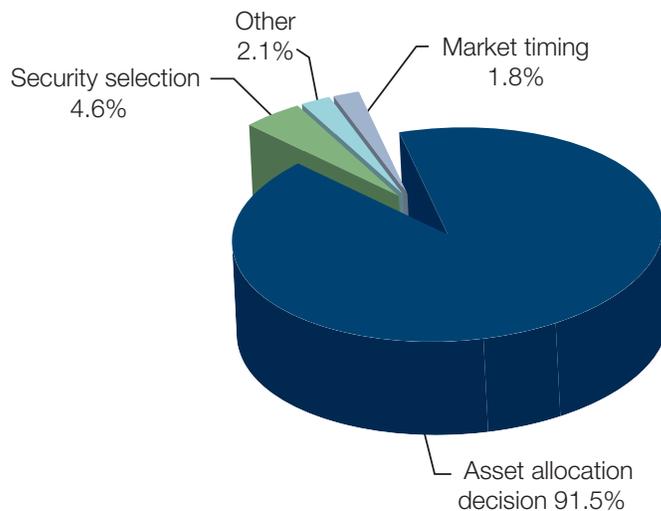
Source: The Financial Analysts Journal, May–June 1991

How Does Asset Allocation Work?

We can see the effect of asset allocation on the volatility of portfolios in pictures. Let's look at the performance of two hypothetical accounts, as illustrated in the graph on the top right of the next page, over a one-year period. In our first account, we'll envision that we take on a typical asset allocation decision and invest $20,000, divided equally between a highly volatile investment (red line) that goes up and down significantly with an investment that goes up and down less. In our example, the volatile investment goes up 12 percent one month before going down 8 percent the next month, and the other investment (blue line) goes up and down half as much (up 6 percent one month and down 4 percent the next). In this example, when our volatile investment goes up, our steadier investment also goes up but only half as much.

Gary P. Brinson, Brian D. Singer and Gilbert L. Beebower, "Determinants of Portfolio Performance II: An Update."
The Financial Analysts Journal, May–June 1991, pages 40–48.

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Conversely, when our volatile investment goes down, our steadier investment goes down only half as much. From the graph, we can see the green wavy line grows about 12 percent to a little more than $23,000 — not bad, but it's a bumpy ride. Investors often use shortcuts and focus only on the 12-percent return number, paying little heed to the accompanying volatility that comes with a potential 12-percent return. At the bottom of a wave, an investor often recognizes a "losing position" when he or she gets scared and sells out of the investment.

In our second hypothetical portfolio, we'll look at the impact of a vital component of efficient asset allocation, a statistical concept called **correlation**, which measures the rate at which the movement of one variable is related to the movement of another. In our case above, every time our risky asset went up, our not-as-risky asset went up, and every time our risky asset went down, our not-as-risky asset did the same. This is called **positive correlation**. What would our second account look like if our two assets had **negative correlation**? This would mean that every time our risky asset went up, our steady asset went down, and every time our risky asset went down, our steadier asset went up.

As you can see from the graph to the right, we still end up with the same 12-percent return and an account value of a little more than $23,000. However, because our investments had negative correlation, the green line is smoothed out quite a bit. The principle of correlation is extremely important in creating a well-diversified portfolio. A basket of investments that perform similarly does not provide as much benefit, especially emotionally, as diversification across investments that perform somewhat differently.

In reality, assets don't have the type of perfect correlations represented in these graphs, but the degree to which assets are positively or negatively correlated is an important component in applying asset allocation principles to a portfolio.

Asset allocation and diversification do not guarantee a profit, nor do they eliminate the risk of loss of principal. There is no guarantee that any investment strategy will be successful.
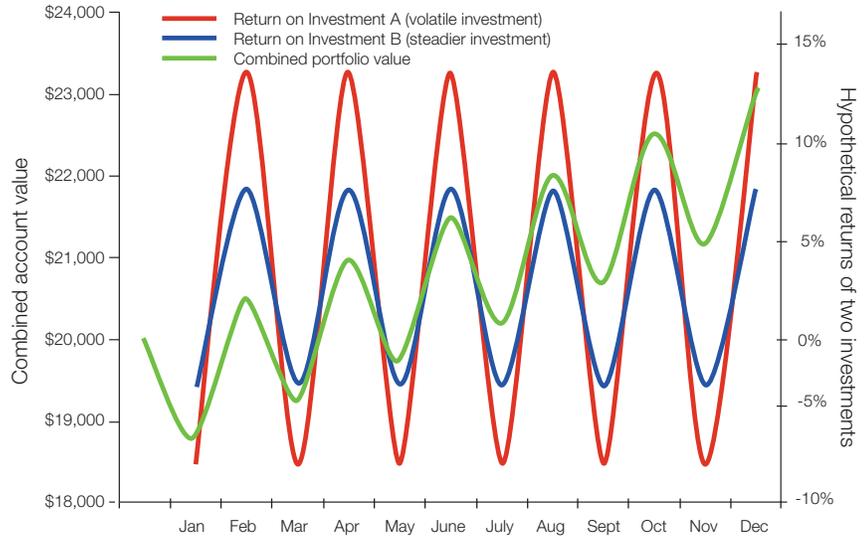
This graph represents the one-year performance of an account comprising two hypothetical investments with positive correlation. This chart is shown for illustrative purposes only and is not intended to predict or depict the returns of any particular investment. Past performance does not guarantee future results.
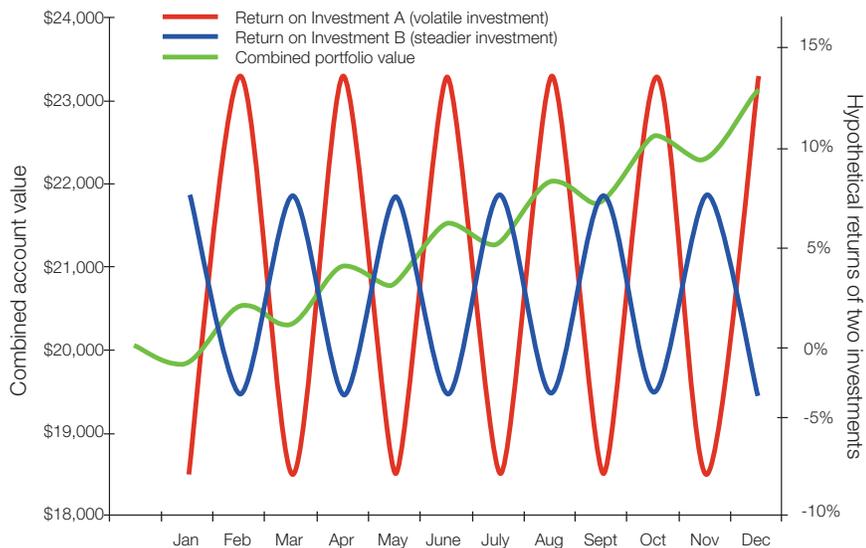
This graph represents the one-year performance of an account comprising two hypothetical investments with negative correlation. This chart is shown for illustrative purposes only and is not intended to predict or depict the returns of any particular investment. Past performance does not guarantee future results.

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The Impact of Asset Allocation on Investor Behavior

One of the biggest challenges you may face in achieving your long-term investing objectives is taming your own emotions. Look back to the first chart of our positively correlated securities. How would you react when your portfolio was on one of the downward sloping lines? Would you react differently to one of the downward sloping lines on the second chart?
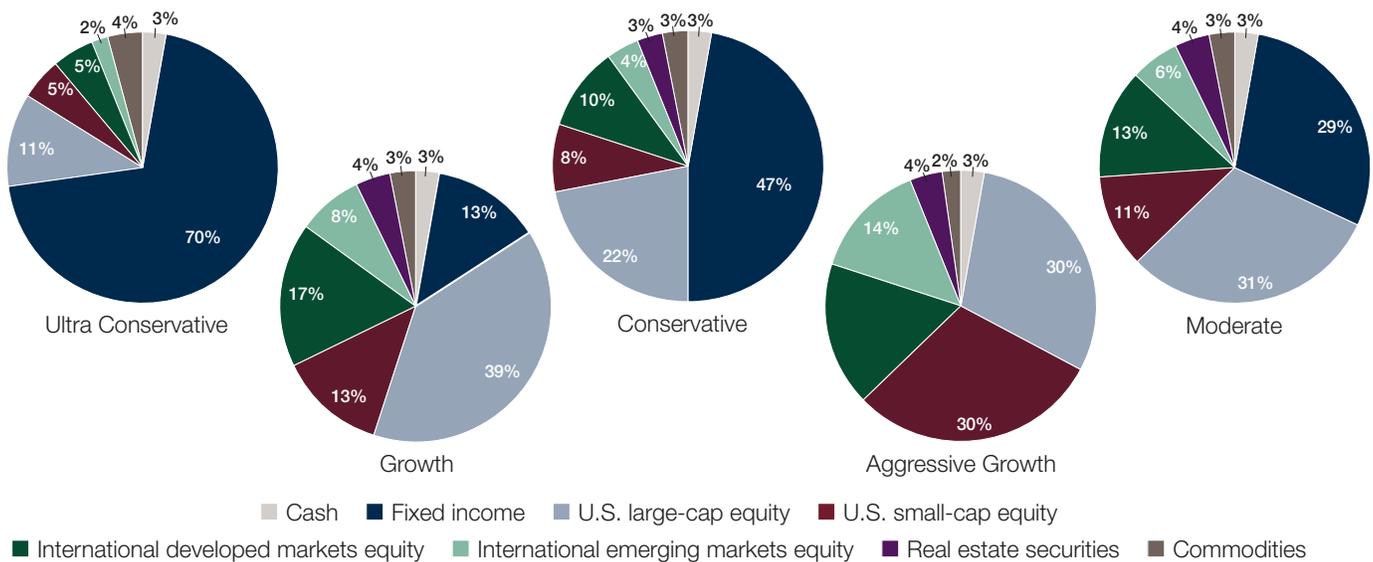
When reacting to emotions, many investors feel compelled to make changes to more volatile portfolios, such as our first one, and are more comfortable managing emotions with less volatile portfolios, such as the second. If smoother returns help you stay the course and stick with your investment program, and both accounts end up in the same place, is

there a tangible benefit to choosing a portfolio with reduced volatility? We believe the answer is yes.

Investors often accept the principle of asset allocation and then make the error of focusing on the performance of individual asset classes, especially those that are more volatile or less correlated and designed to enhance returns and to reduce portfolio volatility. This microscopic and segmented approach to portfolio analysis causes some investors to abandon their overall asset allocation plans in favor of choosing only "hot" investments. This is always a mistake. The best practice is to seek investments that exhibit low correlations and, by doing so, perform differently at different times.

1st Global's Investment Philosophy

The principles of multi-asset class diversification and the benefits of asset allocation are the foundation for 1st Global's investment philosophy. 1st Global is committed to providing sound investment guidance based firmly on academic research, and in 2010, 1st Global began consulting with Dr. Harry M. Markowitz, Ph. D., a pioneer in the field of investment portfolio construction, to assist our Investment Management Research Group in the construction of 1st Global's asset allocation models (shown below).


Ultra Conservative

Growth

Conservative

Aggressive Growth

Moderate

■ Cash ■ Fixed income ■ U.S. large-cap equity ■ U.S. small-cap equity
■ International developed markets equity ■ International emerging markets equity ■ Real estate securities ■ Commodities

The asset allocation models within your personalized investment program may be slightly different than the models illustrated here.

1st Global's asset allocation models utilize eight core asset classes: cash, fixed income (bonds), U.S. large-cap stocks, U.S. small-cap stocks, international developed markets stocks, international emerging markets stocks, real estate securities and commodities. The embodiment of the 1st Global philosophy of appropriate diversification through a disciplined asset allocation are the five model portfolios composed of various blends of eight asset classes. Each model portfolio exhibits a different expected rate of return along with a commensurate level of volatility (risk).

1st Global Advisors Model Portfolios
(Hypothetical data from January 1992 through December 2015)
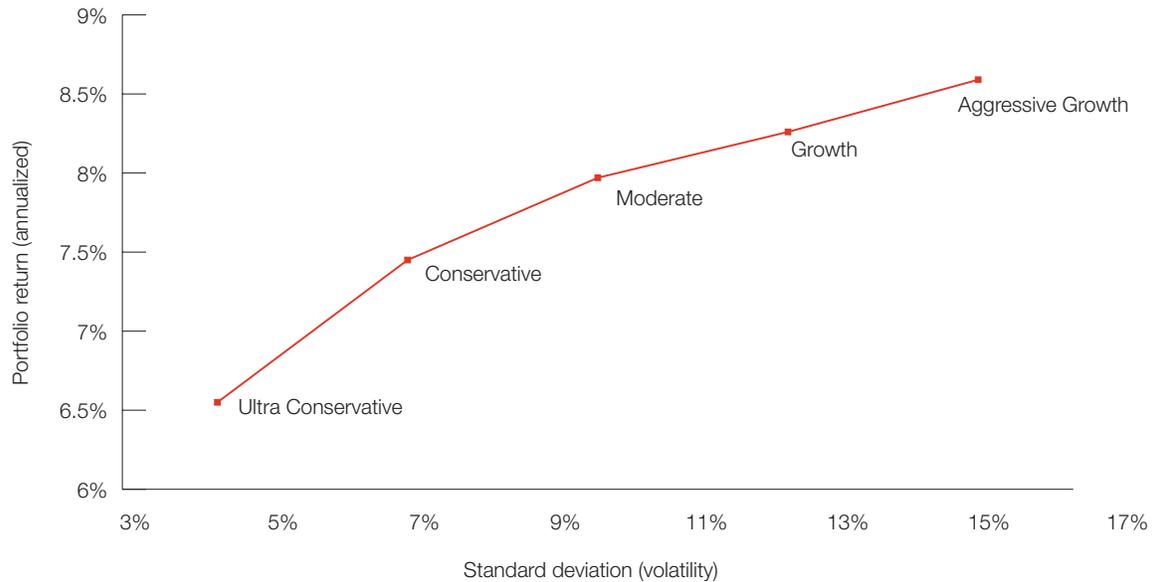
This graph represents the return and volatility (standard deviation) of the 1st Global Advisors, Inc. standard model portfolios, which consist of mixes of indices as represented by the Barclays US Treasury 1–3 Month T-Bill, the Barclays US Aggregate Bond TR Index, the S&P 500 TR Index, the Russell 2000 TR Index, the MSCI EAFE GR USD Index, the MSCI EM GR USD Index, the Bloomberg Commodity TR USD and the FTSE NAREIT Equity REIT TR Index. This chart is shown for illustrative purposes only and is not intended to depict or predict the returns of any particular investment. Past performance does not guarantee future results. It does not show the effects of fees or expenses needed to invest in index-related products.

1st Global's asset allocation models are designed to provide efficient diversification and maximize expected return per unit of risk taken. When selecting individual investments, investors are compensated for accepting greater risk of losses by larger potential returns. For this reason, an increase in expected volatility goes hand in hand with an expectation of the potential for a larger return. Because we know that diversification can reduce overall portfolio risk, we can add riskier assets that carry greater potential for higher returns. While in isolation, individual investments or asset classes may bear risk higher than our comfort levels. By combining these assets with others of differing correlations, we can reduce risk yet still have the potential for higher returns from the riskier assets.

Conclusion

In a world where investors are bombarded by new information offering the "best" funds or the most recent "hot" investment strategy, multi-asset class asset allocation almost seems plain and unexciting. In 1990, however, this approach to rational and consistent investing won Dr. Markowitz a share of the Alfred Nobel Memorial Prize in Economic Sciences. In the nearly 60 years since Dr. Markowitz wrote his first paper on the subject of balancing risk and return in an investment portfolio, the implications of this original study continue to be applicable in asset management. Efficient asset allocation — and not picking the hot or "best" investment product — plays a huge role in determining the road to be traveled and the destination of one's long-term financial goals. As an investor, you increase your chances of achieving your long-term goals by adhering to your asset allocation strategy. However, along the way, it is important to understand that your portfolio will be volatile over short-term periods, and for diversification to truly work, components of your portfolio will likely underperform and outperform at various times relative to other components of the same portfolio.

Delivering multi-asset class diversification through model portfolios offers a framework for you and your financial advisor to make rational investment decisions without fear or greed and provides a baseline against which you can review progress toward long-term investment goals. With the help of a trusted 1st Global wealth management advisor, you can define and document your investor profile (risk and time horizon) and choose a portfolio that meets your requirements for both returns and volatility.

Securities offered through 1st Global Capital Corp. Member FINRA, SIPC.
Investment advisory services offered through 1st Global Advisors, Inc.

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Index Definitions

The Barclays US Aggregate Bond TR Index is a broad-based fixed-income securities benchmark. The index covers the U.S. investment-grade fixed-rate bond market, including components for U.S. Treasuries, government-related securities, corporate securities, residential mortgage pass-through securities, commercial mortgage-backed securities and asset-backed securities.

The S&P 500 TR Index is a free-float market capitalization index of 500 large publicly held U.S.-based companies, capturing 75-percent coverage of U.S. equities. It is often used as a proxy for the American stock market.

The Russell 2000 TR Index measures the performance of the 2,000 smallest companies in the Russell 3000 TR Index and serves as a benchmark for U.S. small company equities. The index represents approximately 10 percent of the total market capitalization of the Russell 3000 TR Index.

The MSCI EAFE GR USD Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. As of May 2016, the MSCI EAFE GR USD Index consisted of 21 developed market country indices.

The MSCI Emerging Markets (EM) GR USD Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of global emerging market equity markets. As of May 2016, the MSCI Emerging Markets GR USD Index consisted of 23 emerging market country indices.

The FTSE NAREIT Equity REITs TR Index includes all equity REITs trading on the NYSE Euronext and the NASDAQ OMX. Equity REITs are defined as those firms that own, manage and lease investment-grade commercial real estate. Specifically, a company is classified as an equity REIT if 75 percent or more of its gross invested book assets is invested in real property.

The Bloomberg Commodity Index TR is a diversified benchmark for commodities and is composed of futures contracts on physical commodities. It uses both liquidity data and U.S. dollar-weighted production data in determining the relative quantities of included commodities. No related group of commodities (e.g., energy, precious metals, livestock or grains) may constitute more than 33 percent of the index.

Disclosures

The indices illustrated in this paper are unmanaged indices of common stocks, bonds or other securities. The volatility of the indices may be materially different from the individual performance attained by a specific investor. In addition, the investor's holdings may differ significantly from the securities in the indices. The indices are disclosed to allow for comparison of the investor's performance to that of certain well-known and widely recognized benchmarks of investment performance. It is not possible to invest directly in an unmanaged index.

Standard deviation is a statistical measurement that sheds light on historical volatility of the returns of a fund or portfolio around its mean return during a given period of time. A higher standard deviation indicates higher volatility and, hence, an enhanced risk of a negative outcome.

Investing in micro, small or mid-sized companies may involve risks not associated with investing in more established companies. Since equity securities of smaller companies may not be traded as often as equity securities of larger, more established companies, it may be difficult or impossible for the fund to sell.

International stocks: Additional investing risks include fluctuations in the value of the U.S. dollar relative to the values of other currencies, custody arrangements made for foreign holdings, political risks, differences in accounting procedures and the amount of public information disclosed by non-U.S. exchange-listed companies.

Emerging market stocks involve greater risk than investing in more established foreign market stocks. Such risks include currency exchange rates, political and economic upheaval, a lack of information about companies, low market liquidity, and differences in financial and accounting standards.

Neither asset allocation nor diversification assures a profit or protects against a loss in declining markets.

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