MONETA INVESTMENT MONTHLY

When It Comes to Portfolio Construction, What's Top of Mind for Investors?

Recently, a study that Vanguard and Spectrem Group jointly conducted on investor behavior indicated that when it comes to investment selection and portfolio construction, the two most important considerations for individual investors are "level of risk associated with investments" and "diversity of investments." According to the data, these concerns intensify as the size of one's portfolio increases, and Moneta takes these into consideration during the portfolio construction process.

Let's take a closer look at each.

Level of Risk

Investment risk comes in many different forms, but what many don't realize is that without a clear understanding and plan for addressing these risks, solving for one risk can often unknowingly increase another.

Here's an example: Many investors come to the conclusion that high-quality fixed income has less volatility, less risk of permanent loss of capital, and a more stable return stream than equities. Knowing this, investors sometimes consider reducing equities and increasing fixed income to lower their portfolio volatility and risk of loss. However, in the current environment of low/negative nominal and real bond yields, this approach increases longevity risk, or the possibility that investors will outlive their assets.

Often this "cause and effect see-saw" happens when investors focus solely on one type of risk, typically, permanent loss of capital. While this is an important risk in portfolio construction, there are others that must be considered and accounted for.

In addition to the previously mentioned longevity and volatility risks, there is also:

- Drawdown risk (or the measure of how long it will take an investor to recoup a substantial market loss from trough to peak price)
- Market risk
- Credit risk
- Liquidity risk
- Reinvestment risk
- Inflation risk
- Horizon risk (or the risk that the investment horizon might be shortened due to unforeseen events)
- Sequence of returns risk

Let's dig into the last one, because it is critical for investors entering the withdrawal phase of their investing lifecycle. Essentially, sequence of returns risk means that your portfolio will have different financial outcomes depending on the state of the economy when you retire.

Here's an example: Warren Buffet recently argued that a diversified portfolio of equities progressively

becomes less risky than bonds over an extended period of time. This is because over long time frames, equities have outperformed bonds and provided a greater degree of purchasing power protection (one of the bigger risks for long-term investors). However, equities also have much greater volatility, and there have been rolling 10-year periods where they have suffered very low and even negative returns.

So, depending on where investors are in their investing life cycle, the sequence of returns could have significant consequences.

For these and many other reasons, it's important to think of risk as multi-faceted and dynamic when constructing a portfolio and deciding which risks can be accepted and which must be solved for.

Diversity of Investments

I was pleasantly surprised to see that “diversity of investments” was a close second when it comes to investor concerns, and actually had the same weight for ultra-high-net worth investors as “level of risk associated with investments” *(Display).*

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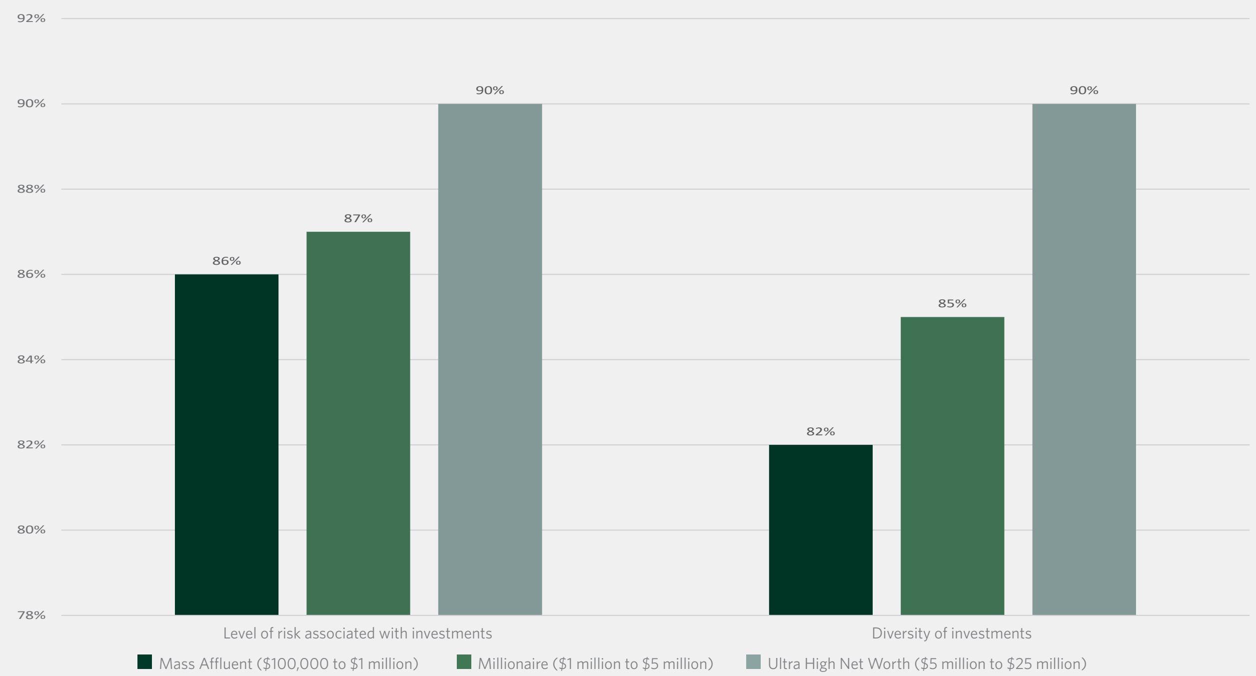
Investors Focus on Risk and Diversity When Choosing Investments



As of December 31, 2016

Source: Spectrem Group and Vanguard

At Moneta, we strongly believe in diversification as a risk management tool, but often worry in times of strong markets that people can lose patience and sight of the benefits of diversification. When building a truly diversified portfolio (as defined by concepts such as correlation and beta), investors must be aware that they are accepting the fact that there will be periods when parts of the portfolio will suffer relatively poor performance. A favorite quote on the subject is: “You know you are diversified when you are always unhappy with the performance of a portion of your portfolio.”

All investors would like a strategy that would allow 100% of their portfolio to participate to the upside and also have little or no downside risk. The only way we know how to attempt to accomplish this is through tactical trading or market timing—strategies that, in our opinion, don’t hold up in the long term. A diversified portfolio narrows the band of expected outcomes versus a concentrated portfolio by providing some downside protection and sacrificing some potential upside. More specifically, a diversified portfolio can provide three main attributes: risk reduction, preservation of capital (particularly for those past the accumulation phase) and the ability to add moderate amounts of riskier assets to potentially generate higher returns.

Consistent with the findings of this study, Moneta believes in strategic asset allocation that focuses on helping investors achieve long-term goals. Additionally, we believe in building panoramic portfolios defined as those that have the potential for multiple time horizons, multiple risk and return opportunities, and active risk management. A thoughtful process of assessing risks and constructing a truly diversified portfolio can help accomplish this.

Bill Hornbarger | *Chief Investment Officer*