Our Approach to Asset Allocation

Executive summary

Building and maintaining an investment portfolio that is able to take full advantage of the opportunities available in today’s markets has become an increasing challenge. This is especially true in an environment with literally thousands of different investment options, a global economy that is undergoing significant changes and a marketplace subject to unforeseen fluctuations. Utilizing an established process that includes the guidance of an experienced team may help enhance an investor’s results.

At The Private Client Reserve of U.S. Bank, we are committed to strategic asset allocation, an investment approach that seeks to produce consistent long-term results, reduce portfolio volatility and manage risk exposure. We believe the most important component of the investment process is determining which asset classes should be used within the portfolio and how much will be invested in each one. This technique is designed to provide stronger performance over the long term by capturing opportunities across multiple asset classes.

Our comprehensive approach applies robust quantitative tools to an individual investor’s unique circumstances in an effort to create a portfolio that is customized to reflect the investor’s specific needs and objectives. We begin our asset allocation process with our view of asset class performance expectations, based on our extensive understanding and research into historical performance and long-term market return, risk, yield and valuation. We also consider the performance relationship between different asset classes through varying market cycles. Our research guides us in creating expected risk and return projections for each asset class, which we use to determine the strategic mix of asset classes for a given level of risk.

Our process involves more than the “science” of data-driven portfolio construction. We also incorporate the “art” of investing, building on our experience to incorporate tactical adjustments to a strategic, long-term investment strategy.

We offer a comprehensive approach to asset allocation to provide you with the opportunity of working towards achieving your specific investment objectives. Our approach utilizes the best the market has offered from a historical perspective, while also taking advantage of our knowledge of what’s happening in the markets and economy today to more effectively manage risk and round out a portfolio’s full performance potential.
It is important to acknowledge that the performance of different investments will vary from year to year. An asset class that generates the best return in one year may lag the performance of all other asset classes in the next year. Additionally, the markets have experienced periods of excessive volatility (such as in 2008), and during these turbulent periods the typical correlation of asset class performance can break down. Because markets fluctuate in unpredictable fashion in the short term, we incorporate a variety of scenarios and market environments in our analysis to reconcile the way asset classes behave under different conditions. The objective is to find the optimal combination of asset classes for the investment portfolio, keeping both short-term and long-term considerations in mind.

Our investment management team assesses historical return, risk and correlation relationships of a wide range of asset classes, including alternative investments. When creating our portfolio strategies, we consider a broad spectrum of investment opportunities, focusing on four primary capital market asset classes:

- **Equities**: includes large-, mid- and small-capitalization stocks, and domestic, developed and emerging international stocks. It also includes alternative investment styles (when appropriate), such as hedged equity funds, structured equity notes, exchange-traded funds and private equity. Active and passive management options are also considered.

- **Fixed income**: includes bonds, bills and notes with various maturities and tax status, from both domestic and foreign issuers. It also includes alternative investment styles (when appropriate), such as structured notes and hedged fixed income funds. Active and passive management options are also considered.

- **Real estate**: includes outright ownership of properties, Real Estate Investment Trusts (REITs), direct real estate funds, and, as appropriate, structured real estate notes. Both active and passive management options can be utilized.

- **Commodities**: includes outright ownership of mining, oil and natural gas properties, and funds that invest in commodity exposures. As appropriate, alternative investment styles, including structured products and investments in private funds are considered. Active and passive management options can be utilized.

Applying the “science” of investing to help shape investment strategies

The “science” of designing a portfolio to potentially achieve specific investment goals over the long term has its basis in the historical performance of various asset classes. The performance characteristics of different investments become easier to distinguish as you examine their long-term trends.

While we know that past performance is not a guarantee of future results, in general we know from historical data that stocks have generated superior returns compared to bonds, which have, over the long term, outperformed Treasury bills. Using these basic assumptions, you might think portfolio structure is a simple task. If you are looking for the highest return—own stocks. If you are looking for lower volatility—own Treasuries. However, the long-term return averages of these different asset classes obscure the reality that over shorter periods of time, asset class performance can vary widely from historical averages. Most notably:

- Historically, the returns of equities have fluctuated the most over short periods of time. Investing only in equities can expose a portfolio to higher risk due to the potential for volatility of returns over shorter periods of time.

- Lower returning asset classes have historically been less volatile, but alone may not generate sufficient performance to achieve stated goals.

### Returns by decades: Four capital market asset classes

![Returns by decades: Four capital market asset classes](image)

Source: U.S. Bank Wealth Management

Asset allocation seeks to identify the optimal combination of these assets to generate the greatest potential return for a given level of risk.

Important disclosures provided on page 5.
Guided by market history, our investment professionals can determine ways to utilize a mix of assets that, in combination, may work effectively to limit volatility while retaining the potential to obtain a more competitive return. As shown below, different portfolio mixes can appear on a “frontier” to demonstrate the level of risk (volatility) that can be expected for a given expected rate of return. Typically, the higher the expected return, the more risk the portfolio is likely to encounter.

**Sample asset allocation strategies**
(tax aware portfolios)

The asset allocation mix designed for an investor can incorporate existing holdings and determine how best to position those assets with other investment options. This strategic approach serves as the foundation of every investment recommendation we make.

Our investment leadership team, including our chief investment officers and senior portfolio strategists, assess the environment regularly to help fine tune the portfolio selection process in relation to the current and anticipated market environment. We believe this is a critical step in maintaining the resilience of an investment portfolio as new analysis techniques and new research drives us to continually improve upon the past. Even our baseline strategic portfolio views are refreshed periodically to update assumptions about specific asset class performance and the particular investment recommendations across asset classes.

**Applying the “art” of investing with tactical adjustments**

While a portfolio structured using a strategic asset allocation is designed with a long-term approach, the reality is that today’s markets and economy are full of events and trends that can significantly affect short-term performance. Short-term, tactical adjustments to a portfolio may help limit downside risk and potentially enhance returns over the long term. Tactical strategies are designed to help complement strategic asset allocations.

Our investment leadership team continuously assesses current economic and market conditions and the performance of specific assets and asset classes, and may recommend tactical changes be implemented to existing strategic allocations.

Portfolio managers make tactical recommendations on a case-by-case basis. This is not a matter of chasing performance. Rather, the insights of our investment professionals are leveraged to help make short-term adjustments in a portfolio mix (typically affecting no more than 10 to 20 percent of all holdings) that may help navigate a long-term portfolio through short-term market fluctuations and position it for potential future developments. This is an ongoing process that incorporates the “art” of asset allocation into a investor’s strategic portfolio mix.

**A personalized solution**

The merit of an asset allocation approach is evident, but as the needs of an investor become increasingly sophisticated, it becomes more important to work with an experienced team that can generate personalized solutions. We help bring broad asset allocation concepts to an individual level by providing recommendations that are specific to the investor’s objectives. Our process incorporates several key elements:

- **A review of the investor’s goals and risk tolerance:**
  The process begins with an in-depth conversation designed to identify current holdings, specific investment objectives (for instance, long-term wealth accumulation or current income), views on investment risk, time horizon and other factors that could impact the structure of the portfolio. We conduct an interview with questions designed to help quantify the investor’s risk tolerance level. We also recognize that any number of variables can affect attitudes toward risk, and will incorporate those factors into the process as well.
Because we emphasize the importance of getting to know specific requirements of each individual, we enhance the potential to create a portfolio that will truly reflect his or her investment desires.

• **Investment holdings:** Other personal factors come into consideration as well. Some have significant dollars invested in a specific asset class—such as real estate or in a concentrated stock holding (i.e., an employer’s company stock). A personalized asset allocation strategy will reflect these holdings and determine how best to build the rest of the portfolio to work well in conjunction with those investments.

• **Tax considerations:** Another important variable is the impact of taxes on investment return assumptions. Our recommendations are structured to provide the optimum return for an acceptable level of risk on an after-tax basis. If taxes are a crucial issue for the investor, they will be factored into the recommended portfolio mix. As tax laws change, portfolios will be adjusted accordingly. In circumstances where portfolios are not directly affected by taxes (such as qualified plan dollars or investments by a non-profit corporation) the asset mix will be structured appropriately.

**A commitment to long-term success**

Once a portfolio is created and implemented, the process continues as long as the money in the portfolio continues to be actively invested in the market. Tactical changes may be recommended periodically, as well as a rebalancing of the investor’s asset allocation mix.

Rebalancing, by definition, involves making adjustments to a long-term portfolio to account for performance variations between asset classes. For example, if over a certain period of time, small-cap stocks have performed well above expectations while large-cap stocks have lagged in performance, the portfolio might eventually drift out of balance. Small-cap stocks may now represent a larger percentage of the portfolio than was intended, while large-cap stocks may be underrepresented. In this example, the investor may be in a position of taking an undesired level of risk. Rebalancing is designed to adjust for this discrepancy, bringing the allocation of asset classes back to the original mix. Rebalancing in this case would require that a portion of the small-cap position be sold while holdings are added to the large-cap position. Before implementing a rebalancing strategy, it is important to account for the tax costs involved in selling appreciated assets (within a taxable portfolio). These trade-offs (rebalancing versus taxes) are reconciled based on each investor’s circumstances in order to more effectively work towards specific investment objectives.

An ongoing commitment to portfolio success also requires frequent reviews of investment progress in relation to the ultimate financial objectives the investor hopes to achieve. A well-managed asset allocation approach takes into account the potential that circumstances in an investor’s life may change. If that’s the case, it is likely that portfolio adjustments will be required. Our professionals are prepared to respond to any individual issues that may need to be addressed within an investor’s portfolio strategy. Such adjustments, if needed, are critical to help individuals stay on track.
A properly diversified portfolio can help reduce overall market risk.

Conclusion

Asset allocation is an approach that can play a vital role in helping investors progress towards their long-term financial goals. We believe the most effective portfolio solutions take into account a combination of factors, including:

- Historical market performance and the relationship of different types of assets invested in combination with each other.
- Individual financial objectives and risk characteristics that can impact the structure of a portfolio. This includes a complete accounting for the individual investor’s perspectives on risk and tax considerations.
- Current market and economic trends that could affect the outcome of a strategic asset allocation mix. Investment professionals put their knowledge of the markets to work to help fine tune a portfolio to potentially capitalize on current trends and the potential future direction of the market.
- Changes in an investor’s specific circumstances that may require adjustments to maintain the optimum portfolio allocation.

All of these factors are woven into creating and maintaining a comprehensive asset allocation solution for every individual investor.

Investment are:

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<th>NOT A DEPOSIT</th>
<th>NOT FDIC INSURED</th>
<th>MAY LOSE VALUE</th>
<th>NOT BANK GUARANTEED</th>
<th>NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY</th>
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Based on our strategic approach to creating diversified portfolios, guidelines are in place concerning how investments should be allocated to specific asset classes based on client goals, objectives and tolerance for risk. Not all recommended asset classes may be suitable for every portfolio. Hedged equity and hedged fixed income investment strategies are typically available via hedge funds, which may not be appropriate for all clients due to the speculative nature and high degree of risk involved in these investments.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. Stocks of small- and mid-cap companies pose special risks, including possible illiquidity and greater price volatility than stocks of larger, more established companies. International investing involves special risks, including foreign taxation, currency risks, risks associated with possible differences in financial standards and other risks associated with future political and economic developments. Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Investment in fixed income debt securities are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors. Investment in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates and risks related to renting properties, such as rental defaults. Alternative investments very often use speculative investment and trading strategies. There is no guarantee the investment program will be successful. Alternative investments may not be suitable for every investor, even if the investor does meet the financial requirements. It is important for investors to consult with their investment professional prior to investment in these investments. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes, and the impact of adverse political or financial factors. Hedge funds are speculative and involve a substantially more complicated set of risk factors than traditional investments in stocks or bonds, including the risks of using derivatives, leverage and short sales, which can magnify potential losses or gains. Restrictions exist on the ability to redeem units in a hedge fund. Structured products are subject to market risk and/or principal loss if sold prior to maturity or if the issuer defaults on the security. Investors should request and review copies of Structured Products and Pricing Supplements and Prospectuses prior to approving or directing an investment in these securities. Private Equity consists of investors and funds that make investments directly into private companies or conduct buyouts of public companies that result in a delisting of public equity. Potential investors should remember that investments in private equity are illiquid by nature and typically represent a long-term commitment. The investments made by private equity funds are not readily marketable and the valuation procedures for these positions are often subjective in nature.