Strategic Asset Allocation
The foundation of our investment approach

Executive summary
Today’s investment markets offer increasing opportunities for individuals looking to build an effective portfolio. At the same time, the rapid growth in the number of investments to choose from and the pace of change in the financial markets can often be overwhelming for individuals. A structured, proven investment approach can be beneficial for individuals as they seek to achieve their key financial objectives.

The foundation of our investment management process is **strategic asset allocation**. At the center of this process is the work of our experienced investment professionals who closely examine the historical return and risk relationships of various asset classes. Their goal is to identify a series of long-term portfolios designed to generate superior returns for a given level of risk. These portfolios incorporate assets from across the globe among four primary capital markets — stocks, bonds, commodities and real estate. Ultimately, investors can select a portfolio mix that is suited to their individual risk tolerance level.

Strategic asset allocation is combined with two other critical steps in our process, our solution platform and portfolio customization. This comprehensive approach provides individual investors with the guidance they seek to craft a personalized investment strategy to help them work toward their specific goals. We help you leverage our vast institutional knowledge of the markets and our experienced judgment about what we believe are effective ways to capitalize on the current investment environment.

Laying a solid foundation
There are many ways for investors to achieve their goals. The most desirable is to earn a targeted return at an acceptable degree of investment risk. The effective management of risk is often the key to withstanding the inevitable unpredictability of the markets because it helps investors maintain a portfolio for an extended period. Staying invested over time is often the key for investors to achieve their primary objectives.

This is the basis for The Private Client Reserve’s strategic asset allocation process. Our work begins by studying how different types of assets have performed historically in relation to each other. We use our understanding of this historical data to create “efficient portfolios” diversified across asset classes. An efficient portfolio is defined as one expected to generate the greatest potential return for a given level of risk.
How strategic asset allocation works

Strategic asset allocation is well recognized as a central tenet of long-term investing and provides a starting point for individuals seeking to achieve their key investment objectives. While asset allocation and diversification do not guarantee returns or protect against a loss, a potential benefit is that an investor owns a diversified mix of assets within a portfolio. Diversification is achieved by understanding the relationship of investment performance between assets, or what is referred to as correlation. This is a method of measuring how the performance of two or more assets compares and contrasts in various types of markets.

For example, two assets are highly correlated — meaning that they demonstrate similar performance characteristics in different environments — the investor achieves little diversification by owning both of those assets. Assets with a low correlation to each other provide the greatest diversification when they are combined in a portfolio. While past performance is not a guarantee of future results, strategic asset allocation can help identify the potential for the most appropriate assets based on historical trends.

Correlation: The only free lunch

The figure above illustrates the concept of diversification through correlation. Asset 1 and Asset 2 are highly correlated, resulting in similar performance characteristics regardless of market environment. The blend of these assets, on the other hand, shows lower correlation, leading to a diversified portfolio with reduced volatility.

Our approach to strategic asset allocation

Not all investment firms approach the asset allocation process in the same way. In The Reserve, we’ve fine-tuned our unique approach, developing efficient portfolios that incorporate:

- A global perspective, diversifying outside the boundaries of the domestic markets.
- A disciplined process that incorporates a variety of factors designed to fully leverage the potential of the capital markets.

Ultimately, we identify a series of efficient portfolios from which an individual portfolio strategy can be developed.

Creating efficient portfolios

The goal of our strategic asset allocation process is to identify a series of efficient portfolios. Each of these portfolios is unique and represents a mix of assets designed to generate the highest expected return for a given level of risk.

These portfolios can be placed along a hypothetical spectrum referred to as the efficient frontier. The spectrum represents different levels of investment risk. An investor determines an acceptable level of risk, and then selects the appropriate portfolio mix along the efficient frontier.

Efficient frontier

The efficient frontier is a graphical representation of the trade-off between risk and return. It helps investors identify the optimal portfolio that maximizes returns for a given level of risk or minimizes risk for a given level of return.

Mixing the best of four primary capital markets

Another key principle of strategic asset allocation is that a portfolio is constructed across a broad universe of asset classes. The process followed at The Reserve begins with four primary capital markets:
• **Equities:** Investors own a stake in a company by purchasing stock. Stocks can be a key driver in a portfolio because they may generate both income (from dividends) and capital appreciation. While stocks have the potential to produce significant returns, stock prices tend to be volatile and less predictable.

• **Fixed income:** Bonds are generally thought to be a more stable alternative for principal than stocks. The return from fixed income investments comes primarily from interest payments. There are risks associated with fluctuations in the broad interest rate environment and with the ability of bond issuers to make interest payments on a timely basis and repay the value of the bond at maturity.

• **Real estate and commodities:** Real estate can include property owned directly or through a vehicle such as Real Estate Investment Trusts (REITs). Commodities include raw materials such as agricultural products, energy products, industrial metals and precious metals. Both asset classes may provide a hedge against inflation but are subject to unique risk factors, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors.

It is important to note that we seek to capitalize on investment opportunities throughout the world across each of these primary capital markets. Within each of these markets are “sub” asset classes. Our asset allocation process utilizes these more specific asset classes to create the most efficient portfolios possible (greatest return for a given level of risk). Here are examples of sub-asset classes within the four broad categories:

• **Global equities:** Large-cap, mid-cap, small-cap stocks, both domestic and global including emerging markets, investment vehicles such as structured equity notes and exchange-traded funds (ETFs), as well as alternative investments such as hedged equity funds.

• **Global fixed income:** Bonds, bills and notes issued by domestic and foreign governments and private entities. This can include taxable or tax-exempt bonds and vehicles such as structured notes and ETFs. Alternative investments include hedged fixed income funds and private debt investments.

• **Global real estate:** Direct ownership of property, REITs, structured real estate notes and alternative investments such as long/short hedge fund structures and direct real estate funds.

• **Global commodities:** Direct ownership of mining, oil and natural gas properties, traditional and alternative funds that invest in commodity exposures, structured products and investments in private commodity funds.

We believe that diversifying globally, not just domestically, is critical to help meet the objectives of strategic asset allocation. We believe that investors have an opportunity to generate modestly higher returns for a comparable level of risk by including global investments in a broadly diversified asset mix.

**A disciplined investment process**

While recommended efficient portfolios are built based on historic returns, risks and correlations for a variety of asset classes, we also assess the current state of the capital markets and optimize desired asset classes to develop efficient portfolios subject to certain constraints.

Among the factors we consider are:

• **Return:** We emphasize forward-looking return assumptions. Our quantitative data focuses on historical returns, but we also incorporate qualitative assessments of asset classes to project realistic future returns.

• **Risk:** Defined as the uncertainty of returns. We utilize historical data to set expectations about volatility of returns for asset classes, but also recognize that risks change depending on economic and market conditions. In particular, certain types of assets may experience unusual performance characteristics during turbulent periods for the markets and economy. This is accounted for in our process.
Strategic Asset Allocation – continued

- **Correlation**: While primarily using historical data as part of our process, we also make adjustments to our assumptions to account for turbulent market periods.

- **Capital markets inputs review**: When we have completed our analysis on the previously identified factors, we review risk-adjusted returns to assure there are no glaring inconsistencies in the data.

- **Optimization**: The step in the process where we take all of the available data and create a series of efficient portfolios across a risk spectrum is referred to as the efficient frontier.

- **Constraints**: We set a maximum weight for certain asset classes, particularly those with less liquidity. We also set a minimum weight of 3 percent for any asset class that has an allocation of more than zero percent in any asset mix.

This disciplined process leads to the creation of different portfolios across various levels of risk on the efficient frontier. One of those portfolios will serve as the basis for structuring an investment portfolio based on a client’s unique objectives.

**Conclusion**

We are firm in our conviction that strategic asset allocation is a critical component in your efforts to meet your long-term investment objectives. We believe that a disciplined, carefully managed process can provide the potential for enhanced returns.

We are strong believers in the value that global investments may provide in a well-diversified portfolio. We consistently monitor for unusual market factors and incorporate our findings, when appropriate, into asset allocation recommendations. Leveraging the experience and knowledge of our investment professionals can help make a difference in the results you expect.
Strategic Asset Allocation – continued

Definition: **Standard deviation** measures the total volatility or anticipated range of a fund or composite's return. It is used by investors as a gauge for the amount of expected volatility.

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**Past performance is no guarantee of future results.** All performance data, while deemed obtained from reliable sources, are not guaranteed for accuracy. Based on our strategic approach to creating diversified portfolios, guidelines are in place concerning the construction of portfolios and how investments should be allocated to specific asset classes based on client goals, objectives and tolerance for risk. Not all recommended asset classes will be suitable for every portfolio. Diversification and strategic asset allocation do not assure profit or protect against loss in declining markets.

**Equity securities** are subject to stock market fluctuations that occur in response to economic and business developments. The value of large-cap stocks will rise and fall in response to the activities of the company that issued them, general market conditions, and/or economic conditions. Stocks of mid-capitalization companies can be expected to be slightly less volatile than those of small-capitalization companies, but still involve substantial risk and may be subject to more abrupt or erratic movements than large-capitalization companies. Stocks of small-capitalization companies involve substantial risk. These stocks historically have experienced greater price volatility than stocks of larger companies and may be expected to do so in the future. **International investing** involves special risks, including foreign taxation, currency risks, risks associated with possible difference 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. Investing in fixed income 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. The risk is usually greater for long-term debt securities. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. 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. 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). An investment in a hedge fund is speculative in nature and involves a substantially more complicated set of risk factors than traditional investments in stocks and bonds. Risk factors include such strategies as short sales, leverage, hedging and non-diversification. Exchange-traded funds (ETFs) are baskets of securities that are traded on an exchange like individual stocks at negotiated prices and are not individually redeemable. Share of ETFs may trade at a premium or a discount to the net asset value of the underlying securities. Structured products are subject to market risk and/or principal loss if sold prior to maturity or if the issuer defaults on the security. Structured Products Pricing Supplements and Prospectuses should be reviewed by the client prior to approving or directing an investment in these securities. Clients should contact their Portfolio Manager directly to request and review Structured Product Pricing Supplements and Prospectuses for each structured product they may wish to purchase. **Private equity investments** provide investors and funds the potential to invest directly into private companies or participate in buyouts of public companies that result in a delisting of the public equity. Investors considering an investment in private equity must be fully aware that these investments are illiquid by nature, typically represent a long-term binding commitment, and are not readily marketable. The valuation procedures for these holdings are often subjective in nature. **Private debt investments** may be either direct or indirect and are subject to significant risks, including the possibility of default, limited liquidity and the infrequent availability of independent credit ratings for private companies.

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