How to Build an All Weather Investment Portfolio

Allison Barrientos, CPA, CFP®
Partner, Integris Wealth Management LLC
www.integriswealth.com  831.333.1717

LEARN MANY OF THE SOPHISTICATED, YET SIMPLE, PORTFOLIO MANAGEMENT PRINCIPLES THAT INSTITUTIONAL INVESTORS EMPLOY, AND HOW TO APPLY THEM TO YOUR PERSONAL PORTFOLIO.

Allison Barrientos, CPA, CFP®
Partner and advisor at Integris Wealth Management
- Local firm managing and advising on approx. $350m assets for 165 clients, primarily high net worth individuals and families

Two professional designations:
- CPA – Certified Public Accountant
- CFP – Certified Financial Planner

Community involvement:
- Legal Services for Seniors – Treasurer
- International School of Monterey – Board Trustee

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Today’s Goal
Learn many of the sophisticated, yet simple, portfolio management principles that institutional investors employ, and how to apply them to your portfolio
What is an “All Weather Portfolio”?  
• It is NOT a guarantee that your assets won’t be subject to risk.
• It is about creating a portfolio that receives the right level of return for the amount of risk being taken.
• Will allow you to have confidence that your portfolio is invested appropriately for your current financial situation, time horizon, and personal comfort level.

"The stock market is a device to transfer money from the impatient to the patient"
-Warren Buffett

Agenda
Review the Fundamentals
Develop a Philosophy
Implement a Process

What is a stock?
Stock: Key Characteristics

- Ownership in a company
- Receive a share of its profits
- Perpetual life (no maturity)

Stock: Varying Attributes

- Size of company
  - Large = $10B+
  - Med = $1.5-$10B
  - Small = $300M - $1.5B
  - Micro = <$300M
- Geography = U.S., Europe, Asia, emerging markets
- Sector = Energy, Finance, Healthcare, etc.
- Value vs. Growth
  - Value = stocks that appear to be undervalued by marketplace
  - Growth = stocks of companies that offer strong earnings growth

Stock: Risk

- Value of a stock is its expected future profitability
- This future profitability is hard to assess with accuracy
- Consequently, share prices can fluctuate dramatically
What is a bond?

Bond: Key Characteristics
- Loan to a company in exchange for interest
- Receive interest payments
- Predetermined life (matures on a specific date)
- Return of principal at end of loan

Bond: Varying Attributes
- Issuer = government, municipality, corporation, mortgage pool
- How interest is paid = coupon vs. non-coupon paying (savings bonds, T-bills)
- Maturity (when loan principal is repaid)
  - Short-term = 1-3 yrs
  - Mid-term = 4-10 yrs
  - Long-term = greater than 10 yrs
Bond: Risk

- Credit Risk (will borrower return principal?)
  - "Risk free" = U.S. government-issued bonds
  - Investment grade = bonds rated BBB or higher by independent rating agency
  - High yield or "junk" = bonds that are below investment grade
- Interest rate risk (changing valuation of bond over time)
  - As current interest rates rise, bonds prices decline
  - Bonds with longer maturity will change in price more dramatically
- Reinvestment risk
  - When a bond matures, interest rates may be less favorable, resulting in a lower income stream

What is a mutual fund?

Mutual Fund: Key Characteristics

- Pooled investment vehicle
- Managed professionally
- Owns portfolio of stocks, bonds, or other securities
- Each investor benefits and loses in equal portion relative to the performance of the portfolio
- Expenses are shared equally ("Expense ratio")
Mutual Fund: Varying Attributes

- What they invest in:
  - Focus = sector, geography, value vs. growth, etc.
  - Active = Manager is making decisions/predictions based on their own judgment & research. Generally attempting to "beat the market"
  - Passive = Manager seeks to closely track a specific index

- Costs:
  - No-load funds = management fees only
  - Load funds = management fees, plus additional sales charge or commission

- Structure:
  - Open-end = mutual fund company sells & redeems shares directly
  - Closed-end = investor must find buyer in the open market

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Mutual Fund: Advantages & Disadvantages

Advantages:
- Can achieve greater diversification
- Professional management
- Ability to invest in almost any type of investment

Disadvantages:
- Fees
- Loss of tax control

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What is diversification?
Diversification: Definition
Investing in different asset classes and in securities of many issuers in an attempt to reduce overall investment risk and to avoid damaging a portfolio’s performance by the poor performance of a single security, industry, or country. – Nasdaq

INVESTING FUNDAMENTALS

"THE STOCK MARKET IS A DEVICE TO TRANSFER MONEY FROM THE IMPATIENT TO THE PATIENT" – WARREN BUFFETT

Markets are generally efficient
Stock markets do a good job of relating risk and return. Current prices represent a consensus of all investors, both optimists and pessimists, who are analyzing the same public information.
Trying to outsmart the market is expensive and counterproductive, and there’s simply no evidence that anyone can do it consistently.
Markets are like the weather

Like the weather, the economy and markets are too complex & chaotic for short-term prediction, however there are deep regularities. Two examples:

- Stocks have higher returns than bonds over long periods.
- Small company stocks have higher returns than large company stocks over long periods.

KEY: Good things take time

Credit: Carl Richards, © 2018, BehaviorGap

Long-Term Expectations

Human beings are fundamentally growth-seeking and resilient, therefore...

The U.S. and world economy are ultimately resilient and biased toward growth, therefore...

The stock market, which mirrors the real economy, is also biased toward growth over the long-term.

Credit: Carl Richards, © 2018, BehaviorGap

Long-Term Expectations (cont’d)
Common biases that impact our investment decisions

• Confirmation bias:
  • Tendency to selectively filter or pay more attention to information that supports our opinions while ignoring the rest
• Regret aversion bias:
  • Aversion to loss leading to an investor taking on less risk because it lessens the potential for poor outcomes
• Hindsight bias:
  • Belief that a past event was predictable and completely obvious whereas it could not have been reasonably predicted
• Familiarity bias:
  • Strong preference toward what we “know” despite obvious gains from diversification

How do we combat these inherent biases to build an all-weather portfolio?

STEP 1: DEVELOP A PHILOSOPHY
STEP 2: IMPLEMENT A PROCESS
STEP 3: DISCIPLINE, DISCIPLINE, DISCIPLINE!

STEP 1: Develop a Philosophy

• FOCUS ON WHAT IS MOST IMPORTANT
• DETERMINE INVESTMENT HORIZON & RISK TOLERANCE
• DETERMINE ASSET ALLOCATION
• RESEARCH & SELECT INVESTMENTS FOR EACH ASSET CLASS
Focus on what is most important

- Focus less on the “talking heads” and more on evidence & research
  - Consider the main goal of most people giving “advice” on television
- Trust the wisdom of crowds
  - Attempting to outsmart the market is time-consuming, costly and ineffective
  - Research shows that focusing on passive investing will yield better long-term results with reduced fees
- Think globally
  - U.S. is still largest stock market, but only about 50% of global markets
- Create diversification
  - Diversification is the only “free lunch” in investing

Determine investment horizon & risk tolerance

Investment horizon
- When will you need the money in this portfolio?
  - The shorter the time horizon, the lower the risk = focus on minimizing volatility
  - The longer the time horizon, the higher the risk = return dominates over the long-term

Risk tolerance
- The degree of volatility in investment returns that an investor is willing to withstand
  - Factors that can affect risk tolerance – investing knowledge, past experiences, objectives
- The shorter the time horizon, the lower the risk

Risk tolerance (cont’d)

Ask yourself the following questions:
- Am I comfortable investing in the stock market?
  - Do I feel confident in my knowledge and understanding of economic issues and personal investing?
- If my investments lose money over the course of a year, can I easily resist the temptation to sell them?
- To obtain above-average returns, am I willing to accept above-average risk?
- When markets decline, do I see it as an opportunity to invest additional funds?

If you answered “Yes” to all of the above, you have a High Risk Tolerance
Determine asset allocation

Determine how much “Growth” vs. “Preservation” you should have in portfolio

- Growth (stocks, real estate, etc.) = Expectation that there will be higher expected returns over the long term but increased volatility in the short term.
- Preservation (high quality bonds + cash) = Provides a stable reserve in the portfolio to either reduce risk or support spending throughout inevitable cycles of stock returns.
- Risk tolerance and time horizon directly dictate the split between “Growth” and “Preservation”

Determine asset allocation (cont’d)

Example 1:
16 yr old opens a Roth IRA account and deposits funds to be used for retirement at age 65. He is keenly interested in the markets and has spent much time researching and learning.

Example 2:
A 75 yr old woman, who is recently widowed and whose only other source of income is her small social security benefit. She has no experience with investing as her husband always handled the finances. She needs to withdraw 4% annually from the portfolio.

Determine asset allocation (cont’d)

Growth: Select combinations of asset classes that create diversification and therefore reduce risk. Examples may include:
- Large U.S. stocks
- Small U.S. stocks
- Large international stocks (developed)
- Small international stocks (developed)
- Emerging market stocks
- Global real estate

Preservation: Add in resilience through bonds & cash to stabilize returns and reduce risk.
- High quality bonds – short or intermediate-term only
- Cash – use only as a reserve, if needed. Low interest rates mean cash is a drag on returns.
Research and select investments for each asset class

- Choose and assemble efficient "building blocks" that provide exposure to each asset class selected
- Mutual funds provide increased diversification and exposure to investments that would otherwise be hard to obtain
- Consider using passively managed funds to reduce fees and provide consistent exposure
- Utilize your broker’s research tools to identify funds that meet your predetermined criteria. Keep an eye out for transaction costs, fees, and minimum initial purchases.

Mutual Funds

Mutual funds allow investors to gain exposure to virtually any asset class, obtain broad diversification, and hire specialized management expertise. However, fund design is critical in delivering long-term results.
STEP 2: Implement a Process

- MONITOR
- REBALANCE
- REPEAT

Monitor

- Check portfolio regularly to ensure
  - Cash is being reinvested or that there is not excess cash being held
  - Contributions are being invested into the appropriate asset classes
  - Time horizon and risk tolerance are still consistent with asset allocation
- Periodically review the specific investments selected to implement your asset allocation
  - Is the fund performing as expected?
  - Has there been a change in fees or manager?
  - Is there now a better option available

Rebalance

Research has shown that disciplined rebalancing of your portfolio back to its target allocation can add up to 0.35% per year in portfolio performance.

Over the course of 30 years for a $100,000 portfolio, that equals $11,051 of return!

BUY LOW, SELL HIGH \( \rightarrow \) REPEAT
Rebalance (cont’d)

**Purpose:** Bring asset allocation back to original target in order to maintain appropriate risk level and reduce potential for concentration

**Frequency:** At least annually, maybe bi-annually. Not too often as transaction costs and tax consequences could negate benefit if rebalanced too often.

**Process:**
- Keep documentation of original target allocation.
- Review current portfolio to determine current allocation and compare to original target.
- Execute appropriate buys/sells to bring current back to target.

**CAUTION:** Select your rebalance frequency and stick with it. Do not adjust your timeline due to market fluctuations.

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Repeat

Continue process of monitoring and rebalancing portfolio indefinitely. Keep in mind that adjustments to target allocation may need to be made to reflect changed circumstances or time horizon.

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**STEP 3: Discipline, Discipline, Discipline!**

ATTEMPT TO REMOVE EMOTIONAL DECISION-MAKING AND FOCUS ON INTELLECTUAL DECISION-MAKING

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This workshop will be available to view on-demand by December 1, 2018. Go to: https://www.monterey.org/library/Events/Financial-Awareness-Workshops.

AND

This workshop will air on Comcast Channels 24 and 25. Check the Program Schedule at https://www.ampmedia.org/channels2/.