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Allocation Matters

There are various ways to diversify equity risk and also potential reward drivers. Below please find a discussion of the current equity allocation that we have been utilizing since joining Raymond James and the rationale behind our process. As you know, we are broadly diversified within the US market via significant allocations to large, mid and small cap stocks. In addition we also have a healthy allocation in international equities with the money allocated 50:50 between emerging markets and developed market economies (e.g. Europe and Japan). I do not know if there is a perfect allocation model but we obviously believe ours is sensible and likely to provide benefit to all of us. It is important for you to understand our thought process as part of our commitment to be completely transparent and hopefully informative as well.

Our Equity Allocation, Rationale and Implementation

There are different ways to look at our equity allocation. The reality is equity markets and segments are related but with important differences. In our portfolio allocations, there are six large component parts, 4 of which receive an allocation of 20% each and the other two share the remaining 20%[i]. They are:

- Our 50 stock model (diversified by economic sector with a focus on above average and growing dividend payments),
- The Russell 3000 (broad US equity),
- The Russell 1000 Value (large and mid cap US "value" sleeve),
- The S&P extended market (mid and small caps),
- The developed world excluding the US, and
- The emerging markets.

Below I have written some additional commentary that explains how together these sub allocations form our US and international, developed world versus emerging economies, large versus mid and small capitalization.

The first component of our equity portion is our 50 stock model of high quality dividend paying stocks. For the most part, these companies are large capitalization U.S. companies that are presently diversified across 9 (of 11) economic sectors. The initial allocation per stock ranges from 1.5% to 3.0% with an average of about 2.0% for each security. Presently the aggregate dividend yield is approximately 2.9% (or roughly 50% higher than S&P 500). Our long-term expectation is for single digit increases in underlying earnings and dividends (perhaps 2% to 6% real) plus the dividend yield. This portion may provide downside support in generally weak environments. On the other hand, it may advance as much in ebullient environments including when international markets are leading returns. The allocation to the 50 stock core is 20% of the total equity allocation.

We allocate another 12% of the equity allocation into the Russell 3000 which composes roughly 98% of all the US market capitalization. Therefore it effectively and tax efficiently ensures you are broadly allocated across capitalization and economic sectors, "growth" and "value" and that you have a cap weighted allocation in each of these roughly 3000 companies including all those that will prove to be the best future winners.

We allocate 8% in the Russell 1000 “value” and also 20% in the S&P extended market (mid and small cap). Lastly, both international allocations (e.g. the developed world ex US emerging markets) also receive an initial allocation of 20% each. So where does all of this leave us? The chart below provides different ways to view the allocation –

Description	Alloc %	US or Int'l	Dev/EM	Mostly large?
Core dividend stocks (core 50 stock allocation)	20.0%	US	Developed	Yes
Broad market US (Russell 3000)	12.0%	US	Developed	YES
Large and Mid Value US (Russell 1000)	8.0%	US	Developed	YES
Mid and Small cap US (S&P extended market)	20.0%	US	Developed	NO
Developed world ex US	20.0%	Int'l	Developed	YES
Emerging Markets	20.0%	Int'l	Emerging	Yes
Resulting ratios				
US versus International	60:40			
US large, mid and small ~	58:32:10			
Developed versus EM	80:20			

As you can see, we have 60% in the US and 40% in non U.S. domiciled companies. We have 80% in the developed world and 20% in emerging markets. Most of the companies, regardless of their nationality, are multi-national in terms of sales, production and scope of their overall operations. About 58% of the US allocation is in mega caps with about 32% and 10% in mid and small caps, respectively. Relative to global capitalization we are overweight (O/W) the US (but we likely hold more in international than most US investors do). Within the US we are O/W mid and small cap in part because of the large cap orientation of the developed and even emerging markets, but more importantly in recognition of diversification principles and history in the US markets. Perhaps most significantly we are O/W emerging markets. This allocation warrants more elaboration. The range of outcomes for emerging equity markets is likely broader than it is for the U.S. and major European markets. In other words, emerging market equities may provide appreciably greater long term growth or they may disappoint. In any case, my hope is that this discussion will help you understand why we want meaningful ownership of all the segments that may add long-term value (growth in principal and income) without “going all in” on any one of the component parts.

The rationale for holding an O/W in the emerging markets (e.g. a greater allocation than their relative share of global market capitalizations) begins with the fact that these markets often perform very differently from the U.S., Europe and Japan. In addition the emerging market economies are where aggregate population, GDP and market value growth has been greatest over many of the past 20 years. If this trend persists, the higher real GDP growth should translate into higher earnings and dividend growth. The value of emerging market economies might also grow modestly over time compared to the US $ (perhaps 1% per year). In addition these economies often exhibit higher rates of inflation so nominal rates of return might be that much greater. This is especially true if the higher rates of inflation are not lost to negative currency adjustments. Put all of these things together and the emerging market allocation could prove to be quite beneficial. Indeed this is one of the segments that may have the greatest chance of growing from an initial allocation of 20% to 30% or more over the coming years. However as with all equity investments, there are significant risks.

The bear case for EM economies and markets is real and could make these investments rather unrewarding. A partial list of potential impediments to economic and financial market growth in emerging market economies includes (but is not limited to):

1. Economic overshoots where there is excess supply in key industries
2. Central Bank or other macro policy errors
3. Global or regional trade or military tensions
4. Potential supply shocks or fallout from pollution
5. Loss of competitive labor and other manufacturing cost advantages (e.g. skilled and unskilled labor alike may be marginalized by greater productivity gains where man is replaced by sophisticated and lower cost machines).

In light of the above potentially positive and negative attributes as well as myriad other factors that make the outlook for EM countries and markets uncertain, we believe our 20% allocation is appropriate. Again the allocation has to be meaningful to be worthwhile but not so great as to mean that the whole portfolio is at risk that can otherwise be controlled.

In summary, we want to own diversified portfolios that will provide significant income in the long term but also reasonable performance along the way. The international allocation will serve as ballast when US markets lag the returns for Europe, Japan and the EM economies. That said as US citizens and residents, we are most influenced by the dynamics of our own economy, currency, etc. so having a majority of allocation in the US makes sense. Moreover most of the time (but not always) when the US markets are performing well, developed world economies and markets are also bearing fruit. Sometimes the emerging market economies and markets perform particularly well and our allocation into them will be important/beneficial. During these periods, our diversified 50 stock portfolio might do well also since many of the companies derive a significant portion of their sales and earnings in the emerging market countries.

Needless to say we will likely continue to see large swings in equity markets here and abroad in the future. Unfortunately, we do not know of any reliable means to predict the timing and magnitude of those changes. Therefore we believe the best approach to build an all-weather portfolio lies in thoughtful and broad, long-term diversification. Recall we are comfortable with market declines, especially for those of you who are adding to your portfolios through periodic savings. For clients who are in distribution mode, we still think ownership of diversified equity portfolios makes a great deal of sense. We just need to build a moat around the equity portion through fixed income and cash so that when inevitable declines occur, we can rely on those reserves to make distributions as opposed to selling equity principal at reduced prices and valuations.

As a species, we do not generally embrace change. However change can be beneficial. Wayne Gretsky said, "Procrastination is one of the most common and deadliest diseases and its toll on success and happiness is heavy." If you are not yet a client but you have been contemplating moving some or all of your securities to us, please know we are confident that our long-term approach will help you reduce costs, increase your tax efficiency and hopefully also position you well for long-term growth in portfolio value and income. Indeed the total incremental cost to own our equity portfolio (above our account level fee) is just 0.11% per year. In other words, we are confident our investment approach will work well for you but again this is merely one component of the value that we bring when serving the needs of our clients.

Please let me know if you have any other topics that you think we should cover. We will likely not be able to opine on near term price levels. We will leave those predictions to others but perhaps there are some long-term issues that we can address.

Warmest regards and best wishes for a wonderful summer!

W. Richard Jones, CFA
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[i] The allocation described here pertains to larger portfolios where ownership of our 50 stock model makes sense from an implementation standpoint. Doesn't this mean that someone can copy our method without becoming a client? Sadly yes, but we trust that most prospective clients recognize two things, namely 1) our fees are reasonable and 2) the investment management piece is just a portion of the advice and service we provide beyond portfolio management which also helps ensure good outcomes. This includes comprehensive financial planning, asset and liability matching and other important wealth management advice.

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