The Anatomy of Your Portfolio

And What to Expect in Return

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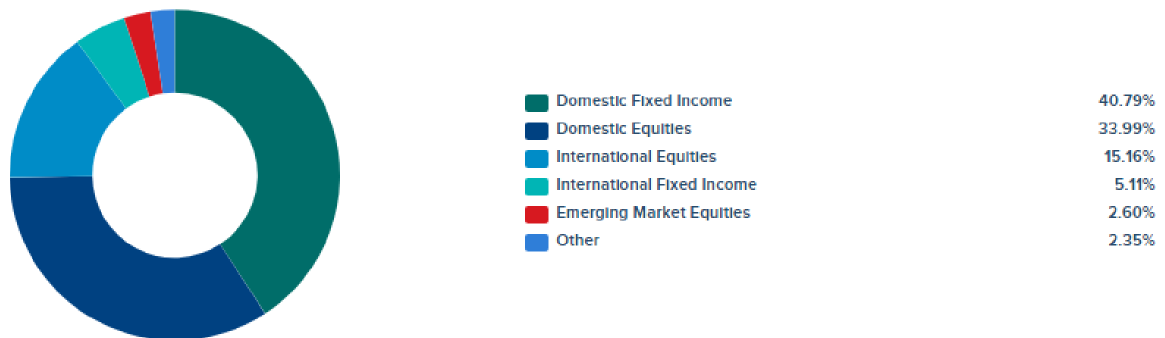
One question we get most often from our clients centers around returns and how to determine what is a "good return" and what is a "bad return." If you've flipped on the TV over the past ten years since the financial crisis, you've likely seen a lot of green arrows and seemingly the market is up on the news. Usually, news broadcasts will follow the three major indexes that are the Dow Jones Industrial Average, the Standard & Poor's 500 ®, and the NASDAQ. **However, when you look at your statement or meet with your financial advisor, your returns may not seem to match what you've seen and want to expect from your portfolio.** This can be a source of frustration and leave you wondering if you're invested correctly.

In this article, we'll explore the anatomy of a well-diversified model portfolio and what leads to the returns such a model portfolio will experience. We'll follow a standard asset allocation used by OWM in 2018. The S&P 500® has returned 10.56% year-to-date (YTD), the Dow Jones Industrial Average has returned 8.83%, and the NASDAQ Composite has returned 15.88%(**this has since changed due to recent pullbacks)**. Compare that with our example of a model portfolio allocation at Omega which, has seen an overall return of 1.92%. So, what gives?

The first place to look is what the asset allocation is. Below is a detailed look of how this overall model portfolio is composed, which includes some more growth-oriented indexes and others that are less stock oriented.



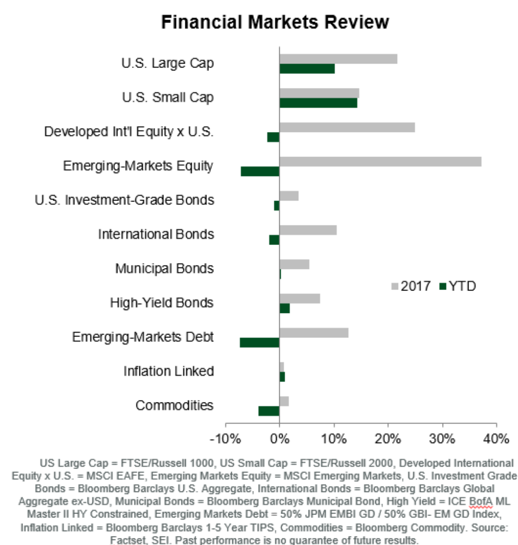
We see that 33.99% of the model portfolio is made up of domestic equities. Domestic equities or U.S. equities are what indexes like the Dow Jones Industrial Average, S&P 500, and NASDAQ track. **Year-to-date the benchmarks that make up the portion of domestic equities in this portfolio illustrated by the FTSE/Russel 1000 for U.S. Large Cap and the FTSE/Russell 2000 for U.S. Small Cap have returned 10.5% and 11.5% respectively - so very much in line with what you'd expect based on the returns we're seeing from the indexes listed above**. But this is only 36.52% of the model portfolio, so what else is going on?

The next largest allocation is Domestic Fixed Income – or U.S. bonds. This makes up 40.79% of the model portfolio. With rising interest rates bond prices are falling, and bond funds have seen poor to low returns as a result. **Currently, the benchmarks that make up this portion of the model portfolio illustrated by the Bloomberg Barclay's U.S. Aggregate Index, ICE BofA ML US High Yield Constrained Index, and Bloomberg Barclay's Muni Index returned -1.60%, 2.52%, and -0.40% respectively.**

International Equities makes up 15.16% of this model portfolio. These are stocks from developed markets like Britain, Germany, Japan, etc. Problems with trade have hampered both international equity performance and emerging market performance (comprising 2.60% of this model portfolio.) **Right now, the MSCI EAFE index, which is the benchmark for the international equity portion of our model portfolio, return -1.43%. Emerging market equities, which make up 2.60% of returns have fared far worse returning -7.68% as shown by the MSCI Emerging Markets Index.**

Lastly, rounding out the model portfolio is the 5.11% of International Fixed Income. Shown by the **Bloomberg Barclays Global Aggregate Ex-U.S. Index, International fixed income has returned -3.03%.**

In **summary, the performance we see right now is a mixed bag. While U.S. stocks are performing very well, the rest of the model portfolio is breaking even to negative returns.**



Diversification

Ok, you might be thinking – "we know that U.S. stocks are doing great, why don't we just buy more of that and sell out of what's doing poorly?" No one could fault you for wondering that, but you'd be falling victim to one of the most common mistakes in investing.

There are plenty of behavioral finance terms to describe this—from market timing to herd mentality to recency bias. All of these describe the act of skating to where the puck currently is and, if you're a hockey fan, you know that will put you in a poor position.

The truth is that there is no telling how asset classes will perform one year to the next. Below is a graph that I love because it shows just how unpredictable the returns can be.

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
International Fixed Income 8.01%	Emerging Markets Equity 79.02%	Small Cap Growth 29.09%	REIT Index 9.37%	Emerging Markets Equity 18.63%	Small Cap Growth 43.30%	REIT Index 32.00%	Large Cap Growth 5.67%	Small Cap Value 31.74%	Emerging Markets Equity 37.75%
Core Fixed Income 5.24%	High Yield Bond 58.10%	REIT Index 28.07%	Emerging Market Debt 8.46%	Emerging Market Debt 18.54%	Small Cap Value 34.52%	Large Cap Value 13.45%	REIT Index 4.48%	High Yield Bond 17.49%	Large Cap Growth 30.21%
Emerging Market Debt -10.91%	Large Cap Growth 37.21%	Small Cap Value 24.50%	Core Fixed Income 7.84%	Small Cap Value 18.05%	Large Cap Growth 33.48%	Large Cap Core 13.24%	International Fixed Income 1.55%	Large Cap Value 17.34%	International Equity 25.62%
60/40 Diversified Portfolio -24.55%	Small Cap Growth 34.47%	Emerging Markets Equity 19.20%	High Yield Bond 4.37%	International Equity 17.90%	Large Cap Core 33.11%	Large Cap Growth 13.05%	Emerging Market Debt 1.23%	Large Cap Core 12.05%	Small Cap Growth 22.17%
High Yield Bond -26.11%	International Equity 32.46%	Large Cap Growth 16.71%	International Fixed Income 4.06%	Large Cap Value 17.51%	Large Cap Value 32.53%	International Fixed Income 9.77%	Large Cap Core 0.92%	Emerging Markets Equity 11.60%	Large Cap Core 21.69%
Small Cap Value -28.92%	REIT Index 28.46%	Large Cap Value 15.51%	Large Cap Growth 2.64%	REIT Index 17.12%	International Equity 23.29%	60/40 Diversified Portfolio 7.55%	Core Fixed Income 0.55%	Small Cap Growth 11.32%	60/40 Diversified Portfolio 15.68%
Large Cap Value -36.85%	Large Cap Core 28.43%	High Yield Bond 15.07%	Large Cap Core 1.50%	Large Cap Core 16.42%	60/40 Diversified Portfolio 16.52%	Core Fixed Income 5.97%	60/40 Diversified Portfolio -0.24%	Emerging Market Debt 10.19%	Large Cap Value 13.66%
Large Cap Core -37.60%	Emerging Market Debt 28.18%	Large Cap Core 15.06%	60/40 Diversified Portfolio 0.70%	High Yield Bond 15.55%	High Yield Bond 7.41%	Small Cap Growth 5.60%	International Equity -0.39%	60/40 Diversified Portfolio 8.77%	Emerging Market Debt 9.32%
Large Cap Growth -38.44%	60/40 Diversified Portfolio 26.28%	60/40 Diversified Portfolio 12.83%	Large Cap Value 0.39%	Large Cap Growth 15.26%	International Fixed Income 1.42%	Emerging Market Debt 5.53%	Small Cap Growth -1.38%	Large Cap Growth 7.08%	Small Cap Value 7.84%
Small Cap Growth -38.54%	Small Cap Value 20.58%	Emerging Market Debt 12.04%	Small Cap Growth -2.91%	Small Cap Growth 14.59%	REIT Index 1.22%	Small Cap Value 4.22%	Large Cap Value -3.83%	REIT Index 6.68%	High Yield Bond 7.48%
REIT Index -39.20%	Large Cap Value 19.69%	International Equity 8.21%	Small Cap Value -5.50%	60/40 Diversified Portfolio 13.41%	Core Fixed Income -2.02%	High Yield Bond 2.51%	High Yield Bond -4.61%	International Fixed Income 5.13%	REIT Index 3.76%
International Equity -43.06%	Core Fixed Income 5.93%	Core Fixed Income 6.54%	International Equity -11.73%	International Fixed Income 5.51%	Emerging Markets Equity -2.27%	Emerging Markets Equity -1.82%	Small Cap Value -7.47%	Core Fixed Income 2.65%	Core Fixed Income 3.54%
Emerging Markets Equity -53.18%	International Fixed Income 2.38%	International Fixed Income 2.48%	Emerging Markets Equity -18.17%	Core Fixed Income 4.21%	Emerging Market Debt -6.58%	International Equity -4.48%	Emerging Markets Equity -14.6%	International Equity 1.51%	International Fixed Income 2.06%

Emerging Markets is my favorite asset class to follow over the years because it is the most extreme example of how unpredictable the asset classes can be:

- 2008 – Worst -53.18%
- 2009 – Best 79.02%
- 2011 – Worst -18.17%
- 2012 – Best 18.63%
- 2015 – Worst -14.6%
- 2017 - Best 37.75%

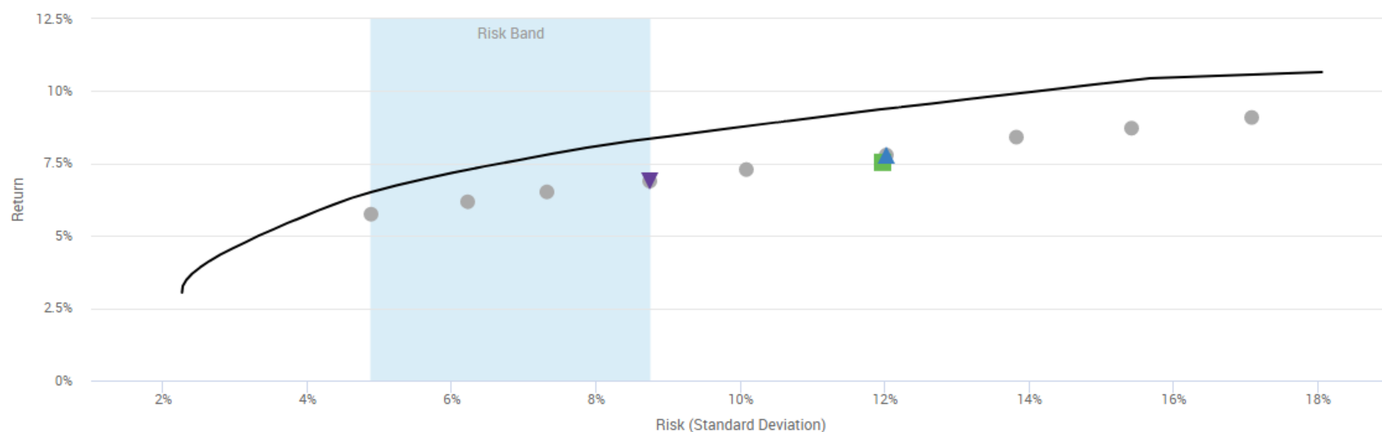
What a ride. Even though there are years where it's down a lot, there are years where it can take off and give you some great returns. This chart does a great job of illustrating how asset classes do well one year and horribly the next. The key is to invest in as many of them as you can, matching that with your risk tolerance and capacity for risk, and timeline for all of your goals.

By diversifying, you are eliminating the peaks and valleys to experience a smoother ride. This is important because you are more likely to remain invested if you can stomach the down years. **For this reason, whenever we are making investment recommendations, we show how the recommended strategy performed in 2008. This illustrates just how bad things can get for the strategy. If you are wondering if you should be more aggressive, ask yourself if you could stomach a -30% drop in your investments, as many of our clients did in 2008, and remain invested.**

Understanding Risk

To best understand risk and investing, you need to look at what is called the efficient frontier. The efficient frontier is a set of optimal portfolios that offers the highest expected return for a defined level of risk or the lowest risk for a given level of expected return.

At OWM, we try to match your risk tolerance with the overall asset allocation of your portfolio. Below is an example of how a hypothetical portfolio that has taken on more risk stacks up on the efficient frontier:



Source: MoneyGuidePro. Please see important disclosures at the end of this article.

In this chart, the Y-axis is measured by the expected rate of return of the model portfolio, and the X-axis is measured by the amount of risk (or standard deviation).

The grey dots are the pre-set hypothetical portfolios created by MoneyGuidePro (the "MGP Portfolios"). The purple triangle shows the MGP Portfolio the program believes the client should have based on their risk tolerance. The green square shows where a hypothetical portfolio that carries a greater degree of risk than the model portfolio falls and the blue triangle on top of the square shows the model portfolio we are using for planning purposes.

Digging into this a bit, let's begin with the MGP Portfolio the program believes the client should have based on their risk tolerances. The MGP Portfolio with the purple triangle has an expected annual return of 6.89% and a risk (or standard deviation) of 8.75%. The standard deviation shows us the return could fall as low as -1.86% or be as high as 15.64% in most years.

To better prepare for retirement, the client has decided to take on more risk to seek a higher return. The riskier portfolio has an expected return of 7.54% and a risk factor of 11.98%. So this portfolio could fall as low as -4.44% or rise as high as 19.52% in most years.

So you can see, as you move to the right on the efficient frontier you begin to take on increased risk for a marginal increase in returns. The most aggressive MGP Portfolio in this illustration has an expected return of 9.09% with a risk factor of 17.09% giving a fluctuation between -8% and 26.18% in most years.

Matching Risk and Diversifying Your Portfolio

To wrap things up we've learned two important lessons. First, the market and asset classes are largely unpredictable from one year to the next. And second, you generally take on an increasing amount of risk to seek higher returns.

Putting these two lessons into practice leads us to a highly diversified portfolio that is allocated based on your risk tolerance, risk capacity (ability to take on risk), and timeline until your goals.

At OWM we take this a step further and match "pools" of assets with your specific goals. For example, we are often more aggressive with monies set aside for retirement because they will have a chance to recover after down market years. We are more conservative with monies designated for your current expenses and goals within the next two years.

As always, if you have questions about how you are allocated or your returns, please don't hesitate to reach out.

Disclosures:

All returns in this piece are as of 9/28/18

S&P 500 Index is an unmanaged, market-capitalization weighted index that consists of the 500 largest publicly traded U.S. companies and is considered representative of the broad U.S. stock market.

Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and NASDAQ.

NASDAQ is an unmanaged, market-capitalization weighted index that consists of all securities listed on the NASDAQ exchange. It is often used to gauge performance of global technology stocks.

FTSE/Russell 1000 Index includes 1000 of the largest U.S. equity securities based on market cap and current index membership; it is used to measure the activity of the U.S. large-cap equity market.

FTSE/Russell 2000 Index includes 2000 small-cap U.S. equity names and is used to measure the activity of the U.S. small-cap equity market.

Bloomberg Barclays U.S. Aggregate Bond Index (formerly Lehman Brothers U.S. Aggregate Bond Index) is a benchmark index composed of U.S. securities in Treasury, government-related, corporate, and securitized sectors. It includes securities that are of investment-grade quality or better, have at least 1 year to maturity, and have an outstanding par value of at least $250 million.

BofA Merrill Lynch US High Yield Constrained Index contains all securities in The BofA Merrill Lynch US High Yield Index but caps exposure to individual issuers at 2%. The BofA Merrill Lynch US High Yield Index tracks the performance of below-investment grade, U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

Bloomberg Barclays Municipal Bond Index is an unmanaged index considered representative of the tax-exempt bond market.

MSCI EAFE Index is an unmanaged, market-capitalization-weighted equity index that represents the developed world outside North America.

MSCI Emerging Markets Index is a free float-adjusted market capitalization weighted index designed to measure the performance of global emerging market equities.

The Bloomberg Barclays Global Aggregate Bond Index (formerly Lehman Brothers Global Aggregate Index), an unmanaged market-capitalization-weighted benchmark, tracks the performance of investment-grade fixed-income securities denominated in 13 currencies. The Index reflects reinvestment of all distributions and changes in market prices.

The Efficient Frontier Graph was prepared by MoneyGuidePro and reflects a set of hypothetical portfolios that assume a low relative level of risk for each level of return, or conversely an optimal return for the degree of investment risk taken. The graph also shows the position of hypothetical portfolios created by MoneyGuidePro. These portfolios are not offered by Omega, nor do they reflect the returns of Omega clients. They are presented simply to show how diversified portfolios might appear on this type of graph. Omega and MoneyGuidePro are not affiliated.