

Ascent Chalk Talk: Asset Allocation

At Ascent, we believe the asset allocation (i.e., investment mix) framework adopted by the investor will be the largest determinant of outcomes for the client over time. Our work begins with an assessment of the client's risk and return expectations. Generally, there is a tradeoff between the two – in other words, to attain higher levels of potential return, an investor needs to accept higher levels of risk. Other inputs to forming an allocation methodology are the client's investment time horizon, tax situation, cash needs, and any other circumstances unique to the client.

We believe there are shortcomings in most conventional asset allocation methods which, in general, assume rational investors and efficient markets, and define risk mostly by statistical measures of variance. The world is more messy and complex than that. We consult a variety of sources in helping to inform our market and investment outlook. We would encourage you to visit the website of GMO (www.gmo.com), an institutional investment manager overseeing some \$97 billion in client assets, for some of the most clear-headed, and accurate, asset allocation insights in the business. Registration is required, and is free.

Ascent's asset allocation work interweaves the following long-term investment themes:

- **The forces of globalization are causing living standards between the developed and emerging economies to converge.** Broadly

In a world facing less organic growth potential, the surety of a growing income return is especially valuable. Dividend-paying equities and real estate investment trusts are strong providers in this category.

speaking, the developed West (the US, the Eurozone, and Japan) is facing below trend growth as populations age, consumer demand patterns change, and social welfare programs burden public finances. Developing world economies, by contrast, are modernizing, growing their consumer class, and moving the technical sophistication of their economies upstream.

- **Central banks, especially in the developed world, are suppressing the natural rate of interest, and debasing their currencies, to stimulate growth.** Bankers are filling a policy void left by their host governments, which are unwilling or unable to prescribe unpopular policy measures for their citizen-voters. Policy fixes (e.g., spending cuts, tax reforms) usually offer long-term benefits, in exchange for short-term pain. However, politicians are elected on the basis of short-term election cycles, and short-term promises, frustrating attempts at lasting structural reforms.

▪ **Growth in the developing world will pressure prices along the value chain of many natural resources, including energy and food.**

Increased automobile adoption in the developing world, and changing developing world diets, as but two examples, will prove disruptive to many industries, and transformative to others.

▪ **The US dollar faces secular decline in its purchasing power over the longer term from slower economic growth and inflationary Fed policies.**

Preserving an investor's purchasing power is a top concern for us. We believe the dollar's long-term value is being eroded, and history supports this contention. For the foreseeable future, though, the dollar will remain a safe haven currency in times of global stress.

Our resulting investment mix is geared to exploit the above themes, as well as others. In particular, we select investment types for their sensibility within our thematic framework, with "extra credit" being assigned for *non-correlated assets*, and *growing real income streams*.

A portfolio gains diversifying benefits when its manager employs non-correlated assets.

In laymen's terms, we want portions of the portfolio "zigging" when others are "zagging," with the entirety of the portfolio trending higher over time. Due to changes in market structure, and to increased market integration, non-correlated assets are increasingly difficult to find; stock markets, for example, have tended to move together in recent years in a pack. Increased correlations between the US and overseas markets have rendered some prior distinctions there essentially moot. So what isn't correlated? Bonds, in general, are still a powerful diversifier versus stocks. Real estate diversifies portfolios, as well. Foremost among commodity-type investments, gold remains a diversifying asset, as well as a hedge against central bank policy error.

Real income streams are what an investor gets to take home after the effects of inflation. Inflation erodes the value of nominal currency

values (say, a periodic, fixed interest payment, such as found on a bond), and is a silent killer of purchasing power. In a world facing less organic growth potential, the surety of a growing income return is especially valuable. Dividend-paying equities and real estate investment trusts are strong providers in this category. Inflation-protected bonds preserve the purchasing power of an income stream, even if they do not grow it. Emerging market debt (in general, though exceptions abound) is a steadily improving credit risk and, if we're right on the trajectory of the dollar, has an upside currency kicker.

On balance, we believe our asset allocation methods, and resultant security selections, to be superior to the rote or mechanistic procedures followed by other practitioners, many of whom diversify primarily for investment advisor herd safety.

We revisit our investment assumptions on a continuing basis. Our investment themes earlier discussed have proved durable for several years, and we expect them to remain operative. The shorter the term of a forecast, say for the year ahead, the more random an outcome is likely. Price and value can decouple from one another, but eventually the market gets it right. To borrow Benjamin Graham's classic maxim, in the short term, the market is a voting machine; in the longer term, it is a weighing machine.

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