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info@cegworldwide.com

(888) 551-3824

CEG Worldwide, LLC

1954 Hayes Lane

San Martin, CA 95046

**Wealth Management Plan, Part Two:**

**Investment Policy Statement**

**Prepared for Mr. and Mrs. Affluent Client**

**March 1, 2020**

Elite Financial Advisor

Elite Financial Advisory Services

1234 Main Street

Santa Monica, California 94000

(310) 555-5555

**Table of Contents**

[Our Investing Approach 2](#_Toc412470188)

[Step One: Assess Your Goals and Circumstances 2](#_Toc412470189)

[Step Two: Set Your Long-Term Investment Objectives 2](#_Toc412470190)

[Step Three: Plan Your Asset Allocation 6](#_Toc412470191)

[Step Four: Select Your Investment Approach 14](#_Toc412470192)

[Step Five: Build Your Portfolio 16](#_Toc412470193)

[Strategic Portfolio Management Process 19](#_Toc412470194)

[Gap Analysis 19](#_Toc412470195)

[Asset Allocation 19](#_Toc412470196)

[Manager Selection 19](#_Toc412470197)

[Rebalancing and Reporting Progress 20](#_Toc412470198)

# Our Investing Approach

Our investing process centers around five steps:

**1. Assess your goals and circumstances.** The investment plan process begins during the Discovery Meeting with a discussion of your financial values and goals, as well as your key relationships, existing assets, other professional advisors, preferred process, and important interests.

**2. Set long-term investment objectives.** Taking into account the long-term nature of successful investing, we set objectives for your portfolio that are appropriate for your willingness, ability and need to take risk, and the investment horizon(s) you identify.

**3. Plan your asset allocation.** Because it is so important, asset allocation is the first investment decision. During this process, we decide how much of your portfolio to invest in each of the different investment types, or asset classes, including stocks, bonds and short-term investments, both domestic and foreign.

**4. Select your investment approach.** With an asset allocation in place, we now select the investment vehicles that you will use to implement your portfolio strategy. Two key investing principles guide these decisions: the importance of diversification and the value of remaining invested.

**5. Build your portfolio.** Building on the first four steps, we construct a portfolio suited to your needs, goals, investment horizon and risk attitude. The building blocks for the portfolio typically are institutional asset class funds or exchange-traded funds (ETFs), an excellent way to implement a diversified portfolio investment so as to maximize the probability of achieving your goals. In the event that an institutional asset class fund or an ETF is not appropriate, retail no-load funds or individual securities may be used.

The result of this process is a diagnostic report of your current situation with our recommendations for repositioning your portfolio to maximize your probability for success. In addition to the above considerations, these recommendations take into account portfolio costs as well as the potential tax impact of the restructuring.

## Step One: Assess Your Goals and Circumstances

Long-term investment success means different things to different people. The best investment plan for you depends on your specific circumstances and objectives. That is why we began the investment planning process with a discussion during our Discovery Meeting of your values, goals, relationships, assets, advisors, preferred process and interests.

While everyone’s situation is unique, certain factors matter in creating any investment plan. These factors include the purpose of the investment, its size, sources and planned uses of the funds, and the amount of uncertainty you are comfortable having. By thinking clearly about your goals and circumstances, you build the foundation of an investment plan that best matches your needs and the realities of the financial markets.

## Step Two: Set Your Long-Term Investment Objectives

Investors know they should be long-term investors. This often gives rise to the question “How long is long term?” The answer for many investors is surprising—your long-term horizon should be as far into the future as possible. One of the many surprising facts about investing is that having a long horizon is a powerful advantage. You want your horizon to be as long as possible, because as an investor, time is your best friend.

For many investors, the most important long-term goal is to achieve financial freedom in order to be able to do what they want. But many investors also have intermediate-term goals—funding college educations for their children, buying vacation homes and founding charitable foundations are but three examples. Investors may also have goals that reach far into the future—for example, they may wish to leave legacies to their children, grandchildren and even great-grandchildren.

Regardless of the time horizon of your goals, the simple fact remains that the more time you have, the more likely you are to succeed as an investor. Why? There are two reasons. The first is the miracle of compound growth. The second is the phenomenon of risk reduction over time.

### The Miracle of Compound Growth

Compound growth operates on a very simple principle. When you put money aside to earn returns, and then reinvest those returns, you have both your original investment and the returns working for you. The longer you allow this process to continue, the greater your accumulation will likely be. Imagine putting $1 million into an investment that consistently earns 8 percent every year. The table below shows how the compounding process works.[[1]](#footnote-1)

|  |  |  |  |
| --- | --- | --- | --- |
| **Year** | **Starting Amount** | **Earnings** | **Ending Amount** |
| 1 | $1,000,000 | $80,000 | $1,080,000 |
| 2 | $1,080,000 | $86,400 | $1,166,400 |
| 3 | $1,166,400 | $93,312 | $1,259,712 |
| 10 | $1,999,005 | $159,920 | $2,158,925 |
| 20 | $4,315,701 | $345,256 | $4,660,957 |

At 8 percent, your investment would grow to more than 4½ times its original size in 20 years. To see the effect of compounding, notice that you would earn $1,158,925 in returns in the first ten years, but even more in the second ten years—$2,502,032.

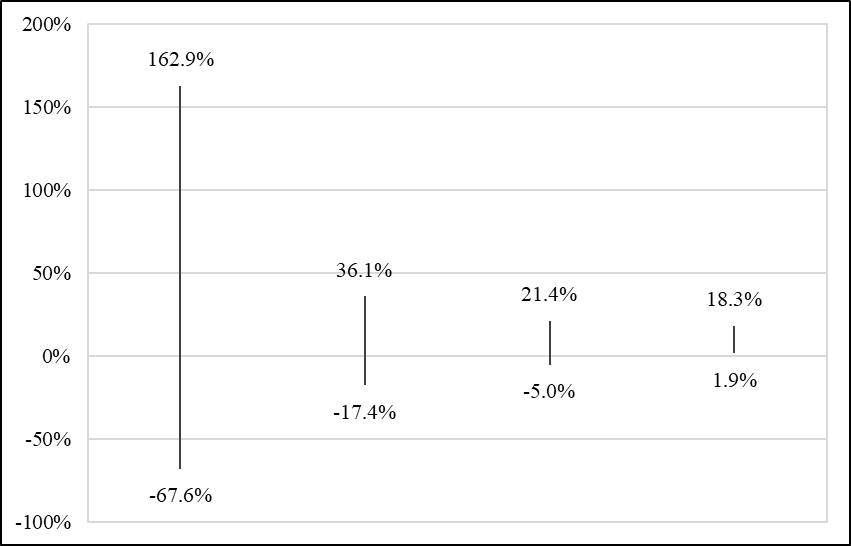
While many people are familiar with the concept of compound growth, they may not be so strongly aware that time actually also helps reduce investment risk, especially in diversified portfolios of stocks. It is natural to worry that if you invest in the stock market today, it may go down tomorrow. But if you have a long investment horizon, tomorrow is just one of the thousands of market days during which you will be investing. Over long periods of time, many of the ups and downs in the market are cancelled out, leaving the broad market trend.

The following graph shows how the range of outcomes for U.S. large capitalized stocks narrows as your horizon becomes longer. It shows the best and worst returns of Standard & Poor’s 500 Index for several time frames from 1926 to 2019.[[2]](#footnote-2) The market has produced a wide range of outcomes. An investor holding stocks for just 12 months could have had returns ranging from a high of 162.9 percent to a low of -67.6 percent. An investor with a ten-year horizon could have experienced annualized returns ranging from a high of 21.4 percent to a low of -5.0 percent. Investors would have had to have been invested for 240 months to have had all time periods result in positive returns.[[3]](#footnote-3)

**Standard & Poor’s 500 Index**

**Best and Worst Returns**

**January 1926–December 2019**



1 Year 5 Years 10 Years 20 Years

Past performance is not indicative of future results. This chart is provided for informational purposes only and should not be relied upon when making an investment decision.

As much as time can reduce your risk, many investors looking at this chart would still feel that the stock market by itself is too risky. In designing your portfolio, we will make use of asset allocation beyond just one asset class, U.S. large capitalized stocks, in order to further reduce risk.

However, it’s important for you to have a long-term perspective with any equity portfolio. The minimum expected investment period should be five years for any portfolio containing equity securities. For any portfolio with less than a five-year horizon, the portfolio should be comprised predominantly of fixed-rate investments. This five-year minimum investment period is important in that the investment process must be viewed as part of a long-term plan for achieving the desired results. This is because one-year volatility can be significant for certain asset classes. However, over a five-year period, volatility is greatly reduced. A time horizon of ten years or longer will serve to increase the likelihood of achieving your financial goals even more.

### Your Attitudes Toward Risk

While we can do a great deal to mitigate risk, we cannot eliminate it. In any investment plan, it is important to understand both the types and the amount of risk you are taking and to be sure that you are comfortable with these. This understanding will greatly increase your ability to adhere to your long-term investment plan and increase your chances of achieving your financial goals.

The right level of risk for you depends on both your personal preferences and your situation. We break the risk equation into the following four parts:

1. Risk Tolerance: Your Response to Market Fluctuations

Over the course of your investment life, the value of your portfolio will rise and fall. While we would always rather see our portfolio value rise, a prudent investor knows that any investment will have some periods in which the value will fall. Equity markets, in particular, are very volatile and investors must expect that there will be regular periods of rising prices and regular periods of falling prices.

Your risk tolerance describes your level of comfort in waiting through the downturns. If the risk you take is within your risk tolerance, then you will be able to maintain your investment strategy through both strong markets and weak ones, giving you the best chance of investment success.

2. Risk Aversion: Your Vulnerability to Losses

Designing an appropriate investment strategy requires understanding and weighing factors that can be in conflict. Your tolerance for risk may be high, but as a prudent investor, you should consider your ability to withstand financial losses. Because market downturns are unpredictable, you need to assess the real economic harm you might face if your portfolio seriously declined in value. If your portfolio failed to provide the returns you had planned for, would you need to adjust your goals?

3. Risk Avoidance: Your Need to Take Risk

Most investors would not choose to take more risk than is necessary. While this is a simple statement, investors often fail to build this concept into their investment planning. Your need to take risk is directly tied to your rate-of-return objective.

If you need your portfolio to grow more quickly over your time horizon, you will want a higher rate of return. An increase in your rate-of-return objective, however, will generally mean taking more risk. If your return objective is higher than your risk tolerance (willingness to take risk) or your risk aversion (your vulnerability to losses), then you must adjust one or more of these parameters. This could mean, for example, retiring later and possibly subjecting yourself to the discomfort of greater risk or increasing your savings.

On the other hand, if your rate-of-return objective can be lowered because your assets can support your goals with less growth, then your need to take risk is reduced and your portfolio should be allocated accordingly. As your portfolio grows over time, your need to take risk should be reassessed and your investment strategy adjusted accordingly.

4. Your Tolerance for Tracking Error: Your Ability to Have Your Portfolio Look Different from Popular Indices

Many investors are more comfortable when they know they are doing as well, or as poorly, as most other investors. A portfolio that tracks the returns of a popular index such as the S&P 500 can provide that comfort, despite the fact that it may not provide the risk management or higher returns that may be available from an effectively diversified portfolio.

*Tracking error* is the amount by which the performance of a portfolio differs from that of major market indices. You should understand your personal tolerance for the tracking error that can result from a portfolio that purposely diversifies away from popular indices in order to decrease volatility and increase expected returns.

Bear in mind that tracking error can be present over lengthy periods. If, for example, your portfolio is weighted heavily toward value asset classes because of the expected higher return over time, it will often look quite different from the S&P 500 index, which is composed primarily of growth stocks. The difference can be either positive or negative, and may be present over many years.

### Rate-of-Return Objective

Every investment choice you make involves a tradeoff between risk and return. In general, a portfolio of safer investments will have less growth potential than a riskier one. To increase the rate-of-return objective, you will typically have to take more risk. Thus, your rate-of-return objective must match the realistic opportunities that you have, given your time horizon and ability to take risk. If your rate-of-return objective is higher than your time horizon and risk attitude permit, then you must adjust one of the three parameters.

All other things being equal, you would most likely prefer to have a higher return. In particular, if two portfolios were equally risky, but one made a higher rate-of-return objective feasible, then you would choose the more rewarding portfolio. One way to construct a rate-of-return objective is to find the portfolio that offers the highest possible rate-of-return objective for your time horizon and risk attitude. In the language of the academic study of investments, this is an *efficient portfolio*.

Over a long investment horizon, a modest increase in your rate of return can make a significant difference in the amount you accumulate. The table below shows the sum to which an initial investment of $1 million will grow over 10 and 20 years at rates of return ranging from 2 percent to 10 percent.[[4]](#footnote-4)

|  |  |  |  |
| --- | --- | --- | --- |
| **Rate of Return** | **Initial Investment** | **Balance After 10 Years** | **Balance After 20 Years** |
| 2% | $1,000,000 | $1,218,994 | $1,485,947 |
| 4% | $1,000,000 | $1,480,244 | $2,191,123 |
| 6% | $1,000,000 | $1,790,848 | $3,207,136 |
| 8% | $1,000,000 | $2,158,925 | $4,6609,57 |
| 10% | $1,000,000 | $2,593,743 | $6,727,500 |

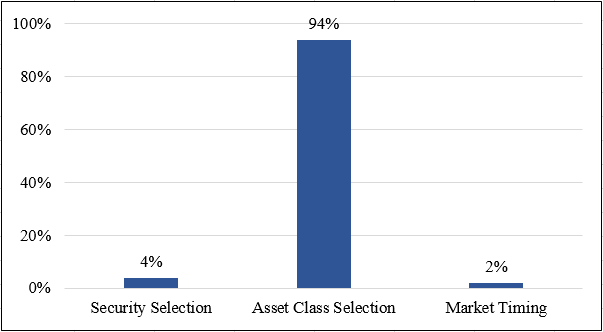
## Step Three: Plan Your Asset Allocation

If you have been careful in setting your long-term investment objectives, then you can be successful in planning your investments. Once we have worked with you to determine your time horizon and risk attitude, and satisfied you with a feasible rate-of-return objective that will meet your needs, we can begin the task of building your investment portfolio. The first step in this process is asset allocation.

Asset allocation is the process of deciding how much of your portfolio to invest in each of the different investment types, or asset classes—stocks, bonds and short-term investments (both domestic and foreign), as well as hard assets such as real estate. Asset allocation should be your first investment decision because it is the most important.

To investigate how important asset allocation really is, three leading American investment experts performed a comprehensive statistical study to measure the importance of various factors in determining a portfolio’s performance. They studied the results of 91 major corporate pension plans over a ten-year period which included both good and bad markets. Their conclusion was that, on average, 94 percent of the variability in returns could be explained by the plans’ long-term asset class policy (see chart below). The remainder was attributable to individual security selection (4 percent) and market timing (2 percent).[[5]](#footnote-5) However, even though security selection and market timing explained 6 percent of the variability of returns, the overall contribution to performance was negative. The average plan lost 0.66 percent per year from market timing decisions and another 0.36 percent from security selection. The authors conclude: “Because of its relative importance, investment policy should be addressed carefully and systematically by investors.”

**Determinants of Investment Portfolio Performance**



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We thus see the importance of investing for the long term, regardless of the management style. This is true because an investment plan’s success cannot be fully realized until the underlying portfolio has gone through the various economic and market cycles that will be experienced over a long period, such as ten years.

### Equities vs. Fixed Income

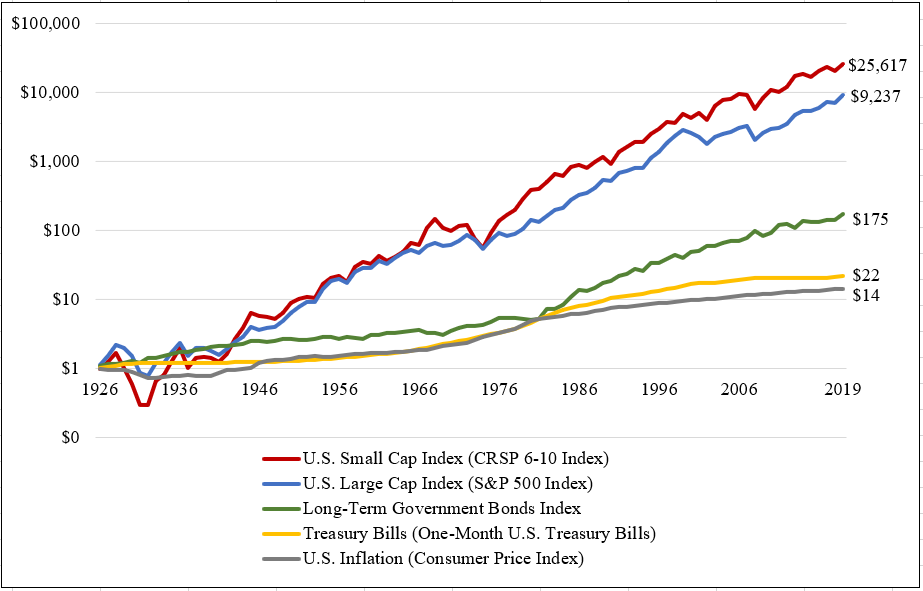
The most basic asset allocation choice is between equities and fixed-income investments. Equities represent participation in the long-term growth of companies and of the economy, while fixed-income investments represent fixed obligations of governments and corporations. It seems natural, then, that equities should offer superior long-term growth potential, while fixed-income investments offer more stability. The choice of allocation between equities and fixed income is a clear example of the basic investment tradeoff between risk and return.

In exploring asset classes, we begin with the historical performance of investment categories. This is not to say that the past indicates future performance; however, it does indicate reasonable relationships between various asset classes.

By referring to the graph below, you can see that historically, equities have far outperformed fixed-income securities. For example, one dollar invested in large cap stocks (as represented by the S&P 500 Index) at the beginning of 1926 would have been worth $9,237 (assuming reinvestment of dividends) by the end of 2019, while an investment in small company stocks would have been worth $25,617. Fixed-income vehicles have trouble even keeping pace with inflation. That same dollar invested in long-term U.S. government bonds would have been worth $175. If invested in 30-day U.S. Treasury Bills, this dollar would have been worth $21. Simply to maintain purchasing power (to stay even with inflation), an investor over this period would have required an increase in value to $14.[[6]](#footnote-6)

**Stocks, Bonds, Bills and Inflation**

**January 1926–December 2019**



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Modern Portfolio Theory, which we will discuss in more depth later, would suggest that investments in equities would be likely to continue to produce higher returns than those in fixed income, given the higher risks inherent in equity markets. These risks are primarily due to the cyclical swings of the stock markets.

These cyclical swings are of greatest concern to those who will have to liquidate their investments in the near future. Typically, the longer one’s investment horizon, the more prudent it is to attempt to achieve a higher rate of return by investing a larger portion of your portfolio’s assets in equities.

That said, there is often a place for both equities and fixed-income investments in a prudently-designed portfolio. In a strongly-rising stock market, some investors are tempted to move to an all-equity portfolio in order to capture those gains. However, such a move can result in dramatic swings in the portfolio’s value, and may leave the portfolio vulnerable to a substantial drop in value once the market has ceased its run-up.

Likewise, other investors, who are near or in retirement, often wish to remain “safe”—to protect themselves from stock market swings—by holding an all-fixed income portfolio. However, as we note below, such a portfolio will tend to achieve returns only approximately equal to the rate of inflation. Without the inflation-beating potential of equities, such a portfolio is subject to a gradual erosion of its value over time.

The bottom line: Building a prudent portfolio requires careful consideration of the unique characteristics of both equities and fixed income and what each can add to the portfolio.

### Fixed-Income Investments

As the long-term returns figures show, an all-equity portfolio has attractive growth potential, but significant uncertainty about the exact outcome. For this reason, we describe an all-equity portfolio as being aggressive. It is most suitable for investors who are willing and need to take substantial risk in the pursuit of reward.

Investors with shorter investment horizons, a high level of risk aversion or less need to take risk should maintain portfolios that are significantly less aggressive than the all-equity strategy. For these investors, some portion of the portfolio should remain in fixed-income instruments. Bonds provide income and help reduce the overall risk in a portfolio. However, because of the fixed nature of the income stream from a bond, there is comparatively little upside potential in a bond portfolio. Investors are sometimes surprised to learn that bond prices can rise and fall with changes in interest rates, but the main source of investment returns from bonds are the interest payments they make.

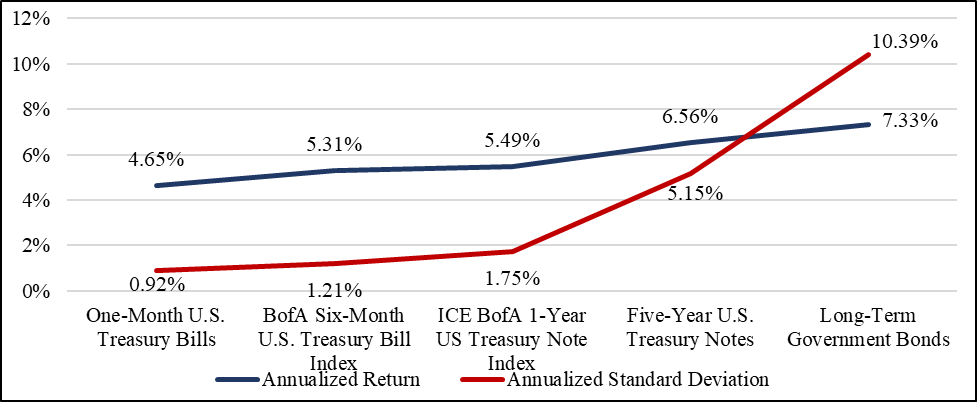
A portion of your portfolio’s assets will be invested in high-quality fixed-income investments. Fixed-income investments will help reduce the overall level of risk in your portfolio, because fixed-income investments tend to be less risky than equities, and because the fixed-income investments represent an additional diversification of your assets. Fixed-income instruments should be used to reduce the overall level of risk to your comfort level. It is important to note that over the long term, fixed-income investments will typically have returns approximate to inflation.

The fixed-income investments for the portfolio will typically be in either short- or intermediate-term bonds. Research by Eugene Fama at the University of Chicago and other respected academicians has shown that long-term bonds historically have had wide variances in their rates of total return without sufficiently compensating investors with higher expected returns.[[7]](#footnote-7) In terms of variability of total return, long-term bonds look more like stocks than shorter-term fixed-income vehicles such as Treasury bills. Yet, over long time periods, their respective total returns have consistently lagged behind those of equities. The graph below helps illustrate the higher standard deviations (volatility) and lower total returns of bonds with maturities beyond five years.[[8]](#footnote-8)

Our purpose in holding some fixed-income investments is twofold; first, to mitigate the risk (volatility) of your overall portfolio, and secondly, to generate income through bond yields. Subject to a given level of risk, we believe a combination of equities and high-quality, short- to intermediate-term fixed-income instruments is the most effective way to achieve your objective of maximizing returns. Replacing the traditional long-term bond holding with a combination of equities and short- to intermediate-term fixed-income vehicles should maintain the portfolio’s expected rate of return while decreasing its volatility.

**Risk and Return Examined for Bonds**

**January 1964–December 2019**



Past performance is not indicative of future results. This chart is provided for informational purposes only and should not be relied upon when making an investment decision.

### Equity Investments

Generally, we will focus your portfolio’s equity investments in “asset class funds” or close proxies for asset class funds. An asset class fund is a mutual fund designed to broadly represent the market, or some significant segment of the market (such as the stocks of large companies or the stocks of emerging foreign markets). These funds invest in a large number of the stocks of their defined segment of the market to provide returns closely approximating the returns offered by that particular segment. By using asset class funds, we hope to lower risk by increasing diversification, achieve market segment returns and minimize costs. By choosing the asset classes that have the highest expected return, we hope to equal the total market’s performance with less volatility. Where asset class funds do not appear, from our research, to be the best or most economical option, we may revert to holding a typical index through the use of an exchange-traded fund (ETF), best described as a “basket” of stocks, designed to replicate a particular index or segment of the market, at the lowest cost available.

### Domestic Equity Investments

We typically chose as our domestic equity asset classes stocks of the U.S.’s largest capitalized companies and U.S. small stocks. We chose these because these groups have the highest expected returns and because academic research shows that the largest and smallest companies’ stocks have low correlation with each other. In other words, in most investment periods, these two asset classes would be the best and worst performers.[[9]](#footnote-9) Building a portfolio containing asset classes with low correlation to each other has been shown to provide greater long-term performance for the investor, while reducing risk through diversification.

The following table highlights the best and worst performing deciles.[[10]](#footnote-10) You can see that the largest movements have generally occurred in the largest and smallest deciles.

**Performance of CRSP Deciles**

**Periodic Returns: January 1926-December 2019**

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Period** | **1** | **2** | **3** | **4** | **5** | **6** | **7** | **8** | **9** | **10** |
| 1926-28 | 109.1% | 89.5% | 85.2% | 87.9% | 110.3% | 66.8% | 86.4% | 49.9% | 60.5% | 103.5% |
| 1929-31 | -61.2% | -71.1% | -74.7% | -76.7% | -73.0% | -82.0% | -79.1% | -84.4% | -85.8% | -88.0% |
| 1931-34 | 32.6% | 83.4% | 111.7% | 115.4% | 92.7% | 154.6% | 113.1% | 222.6% | 280.2% | 447.3% |
| 1935-37 | 25.4% | 33.5% | 7.3% | 11.4% | 22.3% | 23.9% | 32.1% | 17.8% | 33.1% | 51.9% |
| 1938-40 | 21.9% | 15.9% | 23.2% | 27.1% | 45.3% | 43.3% | 39.6% | 40.8% | 10.3% | -8.0% |
| 1941-43 | 24.7% | 54.8% | 50.6% | 51.5% | 62.7% | 56.9% | 99.2% | 102.4% | 125.9% | 278.6% |
| 1944-46 | 45.2% | 72.9% | 77.7% | 91.2% | 92.8% | 108.5% | 100.0% | 114.4% | 153.5% | 175.8% |
| 1947-49 | 29.8% | 26.3% | 28.6% | 20.2% | 19.6% | 14.9% | 14.3% | 6.0% | 6.8% | 17.5% |
| 1950-52 | 78.7% | 78.9% | 72.2% | 71.4% | 74.2% | 67.6% | 79.7% | 73.5% | 70.6% | 69.6% |
| 1953-55 | 92.7% | 79.0% | 88.7% | 77.5% | 79.1% | 93.8% | 81.9% | 69.6% | 87.5% | 94.5% |
| 1956-58 | 37.8% | 51.9% | 44.2% | 55.3% | 45.1% | 35.4% | 51.6% | 41.6% | 55.7% | 38.9% |
| 1959-61 | 42.4% | 47.0% | 53.6% | 51.0% | 51.6% | 45.0% | 47.2% | 49.8% | 50.6% | 40.4% |
| 1962-64 | 29.6% | 25.4% | 23.0% | 18.5% | 9.6% | 13.5% | 14.2% | 19.8% | 7.9% | 14.8% |
| 1965-67 | 19.2% | 35.8% | 56.0% | 69.7% | 85.8% | 101.8% | 99.2% | 118.5% | 136.7% | 175.7% |
| 1968-70 | 3.6% | 3.3% | 9.2% | -8.3% | -1.8% | -0.2% | -13.6% | -11.3% | -20.5% | -11.1% |
| 1971-73 | 22.4% | -1.2% | 1.5% | -0.7% | -12.4% | -10.8% | -19.5% | -22.6% | -30.6% | -31.7% |
| 1974-76 | 14.4% | 43.7% | 60.0% | 62.3% | 79.6% | 69.6% | 82.5% | 97.1% | 85.2% | 98.7% |
| 1977-79 | 11.7% | 26.8% | 46.3% | 53.9% | 69.0% | 97.6% | 95.4% | 108.8% | 103.6% | 123.3% |
| 1980-82 | 45.6% | 58.9% | 65.2% | 70.5% | 80.9% | 81.5% | 75.3% | 72.4% | 88.2% | 82.4% |
| 1983-85 | 71.7% | 73.3% | 67.6% | 61.4% | 61.1% | 69.0% | 61.5% | 73.3% | 56.3% | 38.6% |
| 1986-88 | 42.4% | 42.1% | 46.5% | 46.0% | 34.4% | 27.3% | 27.4% | 22.7% | 13.5% | 3.4% |
| 1989-91 | 71.8% | 60.2% | 60.4% | 55.9% | 58.1% | 51.2% | 43.9% | 39.0% | 25.6% | 7.3% |
| 1992-94 | 14.4% | 28.8% | 26.7% | 28.8% | 45.1% | 40.0% | 38.2% | 29.7% | 41.2% | 63.3% |
| 1995-97 | 132.7% | 110.3% | 98.3% | 99.0% | 74.8% | 91.3% | 106.8% | 89.9% | 104.1% | 87.2% |
| 1998-2000 | 45.7% | 33.5% | 33.9% | 25.4% | 17.0% | 22.7% | 11.0% | 22.1% | 10.3% | -2.1% |
| 2001-03 | -17.4% | 3.4% | 8.0% | 18.0% | 13.3% | 27.1% | 31.0% | 52.8% | 80.0% | 147.3% |
| 2004-06 | 29.4% | 56.3% | 51.0% | 47.0% | 49.7% | 44.5% | 52.7% | 54.8% | 37.1% | 50.7% |
| 2007-09 | -14.8% | -13.8% | -14.7% | -3.7% | 0.1% | -11.2% | -9.6% | -9.3% | -11.1% | -14.1% |
| 2010-12 | 34.1% | 42.0% | 48.6% | 42.6% | 48.6% | 48.6% | 47.8% | 47.0% | 37.2% | 35.2% |
| 2013-15 | 51.7% | 53.8% | 45.8% | 48.0% | 37.7% | 37.0% | 43.0% | 36.2% | 35.9% | 35.4% |
| 2016-18 | 33.3% | 27.4% | 28.4% | 18.5% | 17.3% | 19.7% | 28.6% | 17.3% | 29.2% | 10.7% |
| 2019 | 31.1% | 31.2% | 28.9% | 30.8% | 22.5% | 22.6% | 29.2% | 22.5% | 22.6% | 26.0% |

Past performance is not indicative of future results. This chart is provided for informational purposes only and should not be relied upon when making an investment decision.

It is well documented that, historically, stocks of smaller companies have outperformed the market as a whole. For instance, stocks whose capitalization puts them in the lowest quintile of all stocks (as represented by the CRSP Decile 10) have had an annualized return of 12.85 percent over the 93 years ending in 2019. It is well above the annualized return of 10.2 percent for the S&P 500 Index over the same period.[[11]](#footnote-11)

Occasionally, during what is called the “mid cycle” of economic expansions, stocks which fall in the middle segments of market capitalization, typically referred to as mid-cap stocks, offer predictable positive performance. During these times, we may include mid-cap stocks in your portfolio, typically through the use of an exchange-traded fund.

### Growth vs. Value

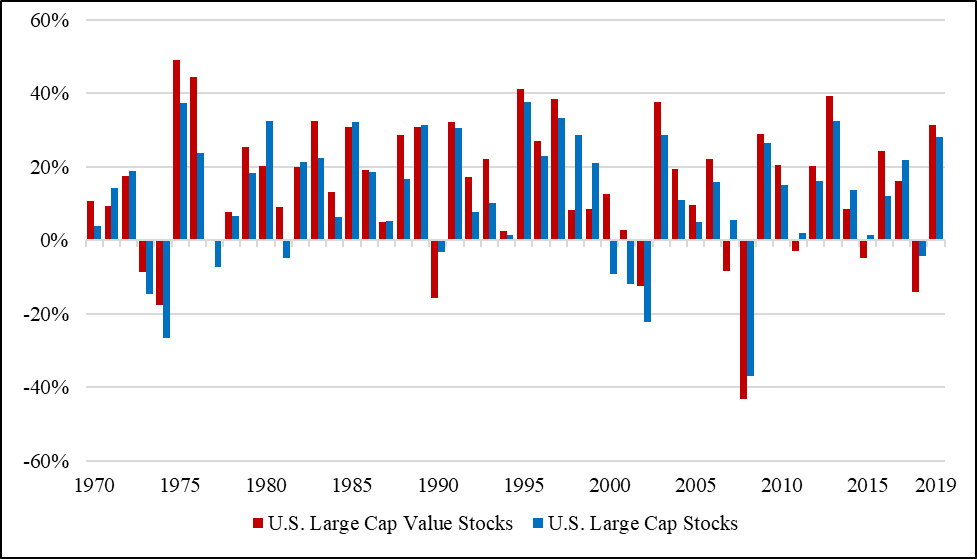
Another important issue to consider when allocating equities in a portfolio is the distinction between growth stocks and value stocks. Growth stocks are generally regarded as those that are expected to grow at an above-average rate when compared to the market as a whole. In contrast, value stocks are generally considered by many to be the “bargains” of the market because they tend to trade at lower prices relative to their fundamentals, such as dividends and earnings.

Because the two styles are so different, it’s unusual that they both work well at the same time. The following chart shows the importance of diversifying between both growth and value stocks.[[12]](#footnote-12) Investment returns in value stocks have outperformed growth stocks at irregular intervals, which emphasizes the importance of maintaining a style-diversified portfolio.

**U.S. Growth and Value Styles Performed Differently**

**January 1970–December 2019**

**Rolling 12-Month Returns**



Past performance is not indicative of future results. This chart is provided for informational purposes only and should not be relied upon when making an investment decision.

### International Equity Investments

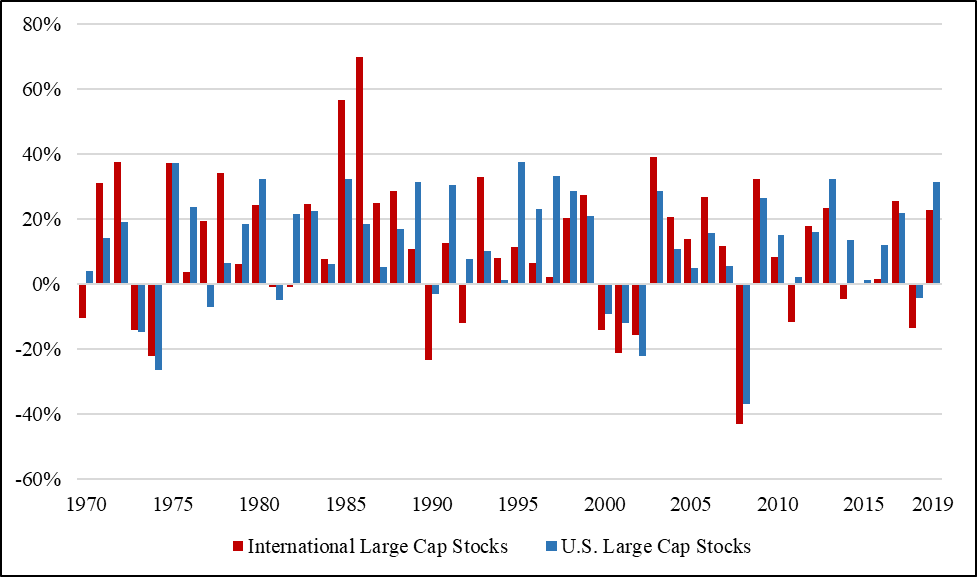
The international and U.S. markets also historically have low correlation. In addition to taking advantage of the high returns attainable in the U.S. equity markets, your portfolio will invest in overseas equity markets. The primary reason for this is increased diversification, which is meant to lower risk. Thus, by diversifying internationally, you can lower the volatility of your portfolio while still enjoying the superior returns of the equity markets.

The chart below shows the importance of global diversification.[[13]](#footnote-13) Investment returns in foreign markets have outperformed domestic-market returns at irregular intervals, which emphasizes the importance of maintaining a globally diversified portfolio.

**U.S. and Foreign Markets Perform Differently**

**January 1970–December 2019**

**Rolling 12-Month Returns**



Past performance is not indicative of future results. This chart is provided for informational purposes only and should not be relied upon when making an investment decision.

When two investments have similar long-term returns, and yet have dissimilar patterns in their short-term outcomes, you can then preserve your portfolio’s growth potential and reduce risk at the same time by investing in both.

A segment of your portfolio will be invested in asset class funds comprised of stocks of small companies outside of the U.S. The small-firm effect has been identified in foreign equity markets as well as in the United States. In fact, available evidence implies that the effect is even stronger in the major foreign markets (i.e., higher return and lower risk).[[14]](#footnote-14)

The important thing to realize is that mixing domestic and foreign stocks is a powerfully advantageous investment strategy. While investors all over the world tend to emphasize investments in their own home markets, if you do not invest in overseas equities at all, you miss two important benefits. First, overseas investments allow you to participate in the growth of the whole global economy. Second, international equities are a powerful diversifier, allowing you to reduce risk without sacrificing the growth potential of equity investments. By investing in small stocks and value stocks overseas, your portfolio will gain even greater diversification from the domestic equities you hold.

### Emerging Market Equity Investments

Most global portfolios include a small portion in emerging markets. In today’s world of equity investing, we are seeing a great deal of growth in emerging markets. The growth rates in these markets have been significantly greater at times than the rate of growth found in established markets. Research indicates that a very small position in emerging markets can increase the return of the portfolio without increasing overall portfolio volatility. In fact, because of the low correlation between the emerging-market asset class and the other asset classes, the allocation may even reduce overall portfolio volatility.

In order to minimize the risk of investing in the inherently riskier realm of emerging markets, we choose funds that have established stringent selection criteria in choosing appropriate countries to include in this asset class.

### Criteria for Country Selection

In order to be considered for inclusion in the emerging-market asset class, a country must have the following:

1. A relatively stable political environment
2. A well-organized financial market
3. A market that provides ample liquidity for its shares
4. A sound legal system that protects property rights and upholds contractual obligations

While these markets are defined as *emerging,* the companies within the asset class are well-established companies in those countries. Typical holdings are the national banks, the land developers and telephone companies of the various countries concerned.

## Step Four: Select Your Investment Approach

As noted previously, the most important factor determining your investment outcome will be your asset allocation. Once you have determined your asset allocation, the next step is to select the investment vehicles that you will use to implement your portfolio strategy. Two important principles of Modern Portfolio Theory should guide this selection: (1) Diversify and (2) Stay invested.

### Elements of Modern Portfolio Theory

The basis for the principles of your investment plan is a collection of the best evidence from the academic disciplines of economics and finance. Investment experts usually summarize this evidence as a body of knowledge called “Modern Portfolio Theory.”

The foundation of Modern Portfolio Theory was a 1952 paper, “Portfolio Selection,” by Dr. Harry Markowitz, in which he established a theory explaining the best way for an investor to choose a portfolio. His basic theory was that investors should choose a portfolio that offers the best return for a given level of risk—the efficient portfolio mentioned previously. Later work by contributors such as Dr. William Sharpe added to our understanding of how to choose the best portfolio from among a specific set of securities.

Modern Portfolio Theory is of such fundamental importance in investing that the economists who formulated the theory received the Nobel Prize in Economic Science in 1990. In addition, most states have adopted Modern Portfolio Theory as the foundation for the prudent-investor rules that govern standards for trustees.

Modern Portfolio Theory has four basic premises. The first is that investors are inherently risk averse. Investors are not willing to accept risk, except where the level of returns generated will compensate them for that risk. Investors are often more concerned with risk than they are with reward.

The second premise is that the securities markets are efficient. A number of studies over time have supported this idea.[[15]](#footnote-15) In fact, advancing information technology and increased sophistication on the part of investors are causing the markets to become even more efficient.

The third is that the focus of attention should be shifted away from individual securities analysis to consideration of a portfolio as a whole, predicated on the explicit risk/reward parameters and on the total portfolio objectives. The efficient allocation of capital in your portfolio to specific asset classes will be far more important than selecting the individual investments.

The final premise of Modern Portfolio Theory is that for every risk level there is an optimal combination of asset classes that will maximize returns. Quantitative methods can be used to measure risk and to diversify effectively among asset classes. Portfolio diversification is not so much a function of how many individual stocks or bonds are involved as it is of the relationship of each asset to every other asset. The percentage and the proportionality of these assets in the portfolio are of paramount importance.

### 1. Diversify

One reason why many investors are reluctant to invest much in the stock market is that they know many stories of companies and stocks that have suddenly fallen on hard times. Some investors imagine an investment in the stock market to be like that—when a stock has gone very high, it may be just the time that it is about to fall sharply. The mistake they make when they think this way is that they forget that while a single stock may rise or fall dramatically, the movements of the overall market are generally much more subdued.

Modern Portfolio Theory provides the reason. It explains that two effects govern the movements of every stock market and stock-specific events. It is primarily the stock-specific events that cause individual stocks to move up or down wildly relative to the overall market. You may think that your best protection against stock-specific risk is to have portfolio managers that know all the companies in your portfolio well. The trouble is, the events that cause the most damage to stocks usually come as a complete surprise. A company may have a sudden product liability problem, or the chairman may die or come under a cloud. On the upside, the company may make a surprise new product announcement, or land a major contract. These events are often unanticipated, and so they cause price movements that not even the best portfolio managers can expect. In fact, Modern Portfolio Theory tells us that if the market can anticipate an event, then the effect of the event is already evident in the stock’s price, and no further profit from knowledge of the event is possible.

If it is surprising that portfolio managers cannot anticipate a stock’s movements, then how can an investor protect a portfolio against them? The answer is diversification. The stock-specific movements of individual stocks may not be predictable, but over a diversified portfolio, they tend to cancel one another out.

Modern Portfolio Theory tells us that we can build diversified portfolios to greatly reduce stock-specific risk, but that market events, which affect all stocks, are not diversifiable. That is, even a diversified portfolio of stocks is subject to the overall movements of the market. Fortunately, the theory predicts that the market rewards us for taking this risk by giving us generous long-term growth potential. The asset allocation decision is where we decide how aggressively to pursue this long-term growth.

### 2. Stay Invested

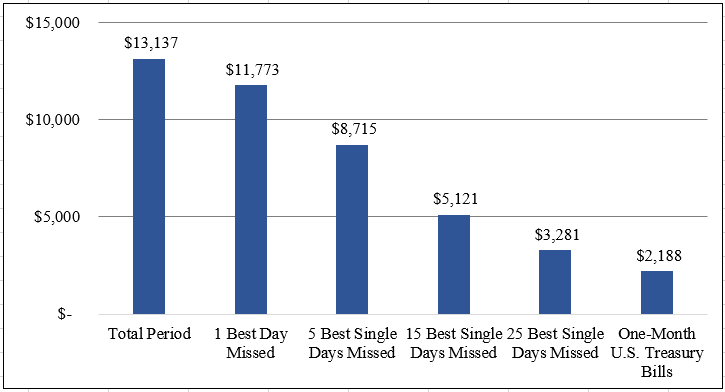
Investors often ask when the right time is to enter the market. For a long-term investor, the answer is today. There is no short-term investment opinion behind that statement. No one can predict the movements of the market for the next month or year.[[16]](#footnote-16) Just as with unanticipated events, if portfolio managers could somehow predict the future movement of the market, then prices in the market would already reflect that knowledge, and so it would be impossible to profit from it.

Even though there is always a danger that the market will go down tomorrow, today is the right day to start investing. The next chart shows why. A large proportion of the long-term gain in investment in the stock market comes from sharp upward bursts. One thousand dollars invested January 1, 1990, in the S&P 500 Index would have grown to $13,137 by December 31, 2018. However, just missing a few of the best days during that time would have resulted in dramatically lower returns than staying invested throughout the period. For example, missing the five best days during that period would have meant that the $1,000 investment grew to only $8,715. And missing out on the 25 best days would have meant that the $1,000 investment grew to just $3,281 by the end of 2018.[[17]](#footnote-17) Smart investors stay invested for the long term.

**Performance of the S&P 500 Index, 1990–2018**

**Hypothetical Growth of $1,000**

**Annualized Compound Returns**



Past performance is not indicative of future results. This chart is provided for informational purposes only and should not be relied upon when making an investment decision.

## Step Five: Build Your Portfolio

For most people, building a truly diversified portfolio is difficult. Imagine that you wanted to build a diversified portfolio of 500 stocks worldwide. To do a good job, you may need to have $5 million or more to invest. Many investors do not have, or choose to invest, this much.

Even if you have enough money to build a diversified portfolio, you may not have enough time. Choosing 500 stocks that you can buy with confidence is difficult enough. Once you had bought the stocks, you would still have a lot of work ahead of you. You would receive masses of information on a large number of companies, and you would have to review your portfolio regularly to decide whether it still suits your objectives. It would be a lot of work to even calculate the performance of your portfolio and decide whether it was good or bad.

An easier way to implement a diversified portfolio is through institutional asset class funds. By buying an institutional asset class fund, in a single transaction you invest in a broad diversified portfolio in a specific asset class. These institutional asset class funds combine your investment with those of other investors to build up a pool of money large enough to buy a diversified portfolio. The portfolio manager’s full-time job is making sure that the securities in the portfolio continue to be suitable for the fund’s investment objective.

### Expected Rate of Return

The term “expected return” is a term of specialized use, which is generally understood to mean the statistically achievable return (based on historical data) over a sufficiently long-time horizon. Expected returns are theoretical returns. They are not estimated returns and are in no way indicative of actual or future performance. In administering the managed portfolios, the expected rate of return of each asset class is the forecast arithmetic annual mean for the next five years. The expected rate of return is recalculated quarterly. These forecasts have been developed using the Capital Asset Pricing Model concept, originally developed by Nobel Prize-winning financial economist William Sharpe of Stanford University. The longest possible time series data have been used, in conjunction with generally accepted investment principles, to arrive at theoretically valid expected returns and standard deviations. (For some asset classes, data are available as far back as 1926.)

### Standard Deviation

The standard deviation is a measure of volatility. In general, the higher the standard deviation, the greater the volatility or risk. An asset class’s annual total return can be expected to fall within one standard deviation of its expected rate of return roughly two-thirds of the time, and within two standard deviations approximately 95 percent of the time. In other words, an asset class with a one-year standard deviation of

5 percent and an expected return of 8 percent would be expected to vary between +13 percent and

+3 percent (±5 percent) about 68 percent of the time, and between +18 percent and -2 percent (±10 percent) about 95 percent of the time.

### Manager Selection for Each Asset Class

Many investors feel that they could have earned better returns than they did during the last few years. Unfortunately, most investors are using the wrong tools and put themselves at a significant disadvantage to institutional investors.

Almost all investors would benefit by using institutional asset classes. An asset class is a group of investments whose risk factor and expected returns are similar. Originally, institutional asset class funds were not available to individual investors. Often, the minimum investment for these mutual funds was in the millions of dollars, effectively removing them from reach from all but the wealthiest investors. That was their goal because these funds were for institutional accounts, such as large pension plans. Working with our firm provides our investors with access to these institutional asset class funds.

There are four major attributes of institutional asset class funds that attract institutional investors:

1. Lower Operating Expenses

All mutual funds, ETFs and separately managed accounts have expenses that include management fees, administrator charges and custody fees. These are expressed as a percentage of assets. The average annual expense ratio for all equity mutual funds was .52 percent in 2019.[[18]](#footnote-18) In comparison, the same ratio for equity ETFs was .18 percent.[[19]](#footnote-19) All other factors being equal, lower costs lead to higher rates of return.

2. Lower Turnover Resulting in Lower Cost

Most investment managers do a substantial amount of trading, believing that this adds value. In 2019, the average turnover rate experienced by investors in equity mutual funds was 28 percent.[[20]](#footnote-20) This means that, on average, 28 percent of the securities in the portfolio were traded over that 12-month period. This represents approximately $280,000 of traded securities for every $1,000,000 invested.

High turnover is costly to shareholders because each time a trade is made there are transaction costs, including commissions, spreads and market-impact costs. These hidden costs may amount to more than a fund’s total operating expenses if the fund trades heavily or if it invests in small company stocks whose trading costs are very high.

Institutional asset class funds have significantly lower turnover because their institutional investors want them to deliver a specific asset class return with as low cost as possible, versus “beating the market” through research, market timing, or tracking a specific index which must be reconstituted periodically.

3. Lower Turnover Resulting in Lower Taxes

If a mutual fund sells a security for a gain, it must make a capital gains distribution to shareholders because mutual funds are required to distribute 98 percent of their taxable income each year, including realized gains to state tax-exemption at the corporate level. They distribute all their income annually because no mutual fund manager wants to have his or her performance reduced by paying corporate income taxes.

In one study, Stanford University economist John B. Shoven and Joel M. Dickson[[21]](#footnote-21) found that taxable distributions have a negative effect on the rate of return of many well-known retail equity mutual funds. They found that a high-tax-bracket investor who reinvested the after-tax distribution ended up with an accumulated wealth per dollar invested of only 45 percent of the fund’s published performance. An investor in the middle tax bracket realized just 55 percent of the published performance. Because institutional asset class funds have less turnover, they often have significantly lower tax.

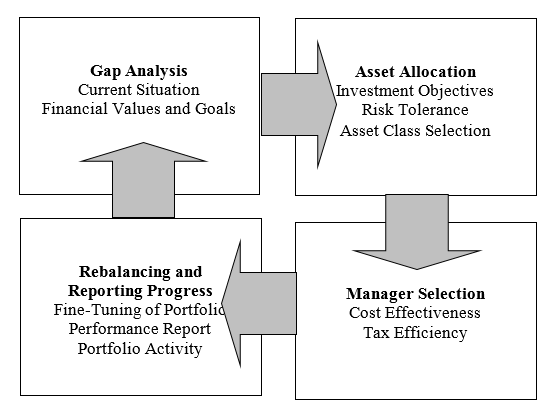
Exchange-traded funds, on the other hand, employ a specific and unique feature which allows them to perform “like kind exchanges” when they must change the holdings within the ETF. As a result, they typically make far fewer capital gains distributions than mutual funds.

4. Consistently Maintained Market Segments

Most investment advisors agree that the largest determination of performance is asset allocation—how your money is divided among different asset categories. However, you can only accomplish effective asset allocation if your investments in your portfolio maintain consistent asset allocation. That means your funds need to stay within their target asset classes. Unfortunately, most retail funds effectively have you relinquish control of your asset allocation as they overweight particular parts of the market in their quest to achieve higher rates of return than the market as a whole. In contrast, because of their investment mandates, institutional asset class funds and ETFs must stay fully invested in the specific asset class they represent.

# Strategic Portfolio Management Process

The financial goals and values you shared with us at our Discovery Meeting have become the basis for your investment plan, as well as our Strategic Portfolio Management Process. This is not a one-time event, however. The Strategic Portfolio Management Process that we use is constantly ongoing to ensure that we are on track to achieve those goals and values. It is vital in managing the investment component of your overall wealth management plan. The process has four distinct parts, as illustrated below.



## Gap Analysis

This is an ongoing evaluation of your current situation. We reassess where you are now, where you want to go, and consider any actions or changes that may be necessary to maximize the probability of achieving all that is important to you.

## Asset Allocation

As we have discussed, we use Modern Portfolio Theory to determine that your account has the proper asset class selection to meet your financial goals. Change is one thing of which we are certain, and because proper asset allocation is so important, we periodically review each asset class to determine if it is still appropriate to your overall plan.

## Manager Selection

While decisions about asset allocation are the most important decisions to be made about your portfolio, we also evaluate the managers on an ongoing basis. In particular, we look for their ability to deliver consistent returns within their asset class in a cost-effective and tax-efficient manner. This is particularly important in the fixed income portions of your portfolio or specific market segment where we may choose to use a no-load retail fund because of compelling research which indicates that active management has a high probability of offering an advantage over a passive strategy. In particular, there exists compelling research which indicates that active management may offer predictable “alpha” (the ability to capitalize upon market inefficiencies, thereby increasing returns and reducing risk) in the following asset classes: World Stock, Real Estate Securities and International Fixed Income.

## Rebalancing and Reporting Progress

During our Regular Progress Meetings, we will ask you about any specific events in your life that may call for a change in your portfolio. These events might include, for example, the birth of a child or grandchild, the death of a parent or a change in your marital status. When changes in your situation indicate that changes and rebalancing in your portfolio are warranted, we make these as needed. Additionally, we will perform periodic rebalancing operations within your portfolio as economic and market conditions dictate.

We will also report on how your portfolio has performed, as well as specific activity in the portfolio, at our Regular Progress Meetings.

1. Figures are for illustrative purposes only and are not a guarantee of future performance. Figures do not reflect the effect of fees or taxes. [↑](#footnote-ref-1)
2. U.S. large capitalized stock performance calculations are based on average annualized rolling returns of the Standard and Poor’s 500 Index, an unmanaged index intended to represent the performance of a diversified portfolio of large cap U.S. stocks. [↑](#footnote-ref-2)
3. Dimensional Fund Advisors, Returns program, updated through 2019. [↑](#footnote-ref-3)
4. Figures are for illustrative purposes only and are not a guarantee of future performance. Figures do not reflect the effect of fees or taxes. [↑](#footnote-ref-4)
5. Gary P. Brinson, L. Randolph Hood and Gilbert L. Beebower, “Determinants of Portfolio Performance,” *Financial Analysts Journal*, July/August 1986. [↑](#footnote-ref-5)
6. Dimensional Fund Advisors, Returns program, as updated through 2019. [↑](#footnote-ref-6)
7. For example, see Edward L. Martin, “Intermediate-Term Bonds,” *AAII Journal*, January 1991, pp. 13-16. [↑](#footnote-ref-7)
8. Treasury instruments 1964-2019: Dimensional Fund Advisors, Returns program. [↑](#footnote-ref-8)
9. Dimensional Fund Advisors, *U.S. Small Company Strategy.* [↑](#footnote-ref-9)
10. Deciles 1-10 of NYSE (plus AMEX equivalents since July 1962 and NASDAQ equivalents since 1973). CRSP: Center for Research in Security Prices, University of Chicago. [↑](#footnote-ref-10)
11. Dimensional Fund Advisors, Returns program, as updated through 2019. [↑](#footnote-ref-11)
12. Returns for the S&P 500 Index and the Dimensional Large Cap Value Index. Dimensional Fund Advisors, Returns program, as updated through 2019. [↑](#footnote-ref-12)
13. Returns for the S&P 500 Index and the MSCI EAFE Index. Dimensional Fund Advisors, Returns program, as updated through 2019. [↑](#footnote-ref-13)
14. Dimensional Fund Advisors, Inc., “International Small Company Stocks—A New Dimension for Institutional Investors” (1987); also “International Small Companies,” a DFA presentation (1990). Updated, 2002. [↑](#footnote-ref-14)
15. See Eugene F. Fama, “The Behavior of Stock Prices,” *Journal of Business* (January 1965); Michael C. Jensen, “The Performance of Mutual Funds in the Period 1945-1964,” *Financial Analysts Journal* (November 1989); Richard A. Ipolitto, *American Economic Review* (1964); and Edwin J. Elton et al., “Efficiency with Costly Information: A Reinterpretation of Evidence from Managed Portfolios,” *Review of Financial Studies* (1993). [↑](#footnote-ref-15)
16. For an intelligent and entertaining discussion of this issue, see Burton R. Malkiel, *A Random Walk Down Wall Street.* [↑](#footnote-ref-16)
17. Dimensional Fund Advisors, “Market Declines and Volatility.” [↑](#footnote-ref-17)
18. 2020 Investment Company Fact Book, Investment Company Institute. Expenses calculated on an asset-weighted basis. [↑](#footnote-ref-18)
19. 2020 Investment Company Fact Book, Investment Company Institute. Expenses calculated on an asset-weighted basis. [↑](#footnote-ref-19)
20. 2020 Investment Company Fact Book, Investment Company Institute. Turnover calculated on an asset-weighted basis. [↑](#footnote-ref-20)
21. A study commissioned by Charles Schwab and conducted by John Shoven, a Stanford University economics professor, and Joel Dickson, a Stanford Ph.D. candidate, measured the performance of 62 equity funds for the 30-year period from 1963 through 1992. [↑](#footnote-ref-21)