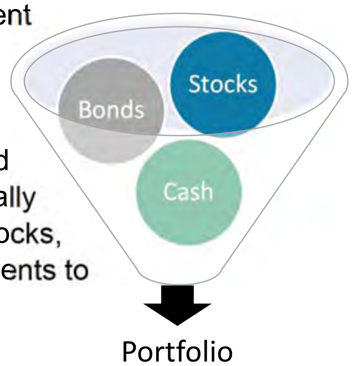
Defining the Investment Universe: What Our Portfolios Own, and What They Don't

By constructing portfolios with building blocks that are familiar, investors can understand how their portfolio should perform in both good and bad economic times

The universe of potential investment is extremely broad and complex. This can often be intimidating for investors, as the hardest part tends to be deciding where to start first. Although there are many unique areas within the realm of stocks and bonds, as well as many outside of these traditional asset classes, our general approach to investing focuses on the broadly used and easier to understand areas of the markets. In our view, this helps to avoid the "analysis paralysis" that often results in investors staying in cash longer than they should. Most importantly, by constructing portfolios with building blocks that are generally familiar, investors can often understand how their portfolio should perform in both good and bad economic times.

The Primary Asset Classes

In order to organize the nearly infinite universe of investments, we separate each type of investment into a specific bucket or asset class. These asset classes are very broad and contain all the different types of investments that fit that category. Our approach to the markets leads us to divide the entire investment universe into five asset classes: Cash, Bonds, Stocks, Commodities, and Alternatives. From our perspective, we generally focus on the three primary asset classes of Stocks, Bonds, and Cash, as they provide ample investments to navigate a portfolio throughout economic cycles.



The Bond Asset Class

Bonds provide two critical pieces to an overall investment portfolio: stability & income

In constructing balanced portfolios, we see Bonds as an important component for nearly every risk profile. In our view, Bonds provide two critical pieces to an overall investment portfolio: stability and income. On the stability side, they tend to have very little price changes relative to stocks, making them significantly less volatile than stocks. On the income side, bonds also have a pre-established level of income that will be paid to their investors. This is often why bonds are referred to as "fixed income" investments. These interest or coupon payments provide a dependable level of income and return for investors that is generally not impacted by the economic cycle (unless the issuer goes into financial distress). Absent a bond defaulting on their payments, investors usually have a consistent schedule of payments for any bond that they own. In our view, this makes bonds one of the key asset classes to own in most balanced portfolios.

Within the Bond Asset Class, we focus on U.S. Government Bonds, U.S. Corporate Bonds, and U.S. High Yield Bonds

Since the bond asset class is very large, we make a further differentiation around which types of investment are candidates for our investment portfolios. We view the following smaller buckets or sub-asset classes as key components in the bond asset class:

- **U.S. Government Bonds:** Bonds that are issued by the U.S. Government or other agencies guaranteed by the U.S. Government fit into this sub-asset class. These bonds tend to be the least likely to default as they are backed by the Federal Government. They tend to be a source of stable income for portfolios as well as have an extremely low likelihood of default. Due to their relatively steady nature, they tend to reduce overall volatility across a portfolio. For tax sensitive accounts, we may choose to implement with **Municipal Bonds**. Although these have similar characteristics as U.S. Government Bonds, they are issued or guaranteed by individual states instead of the Federal Government.
- **U.S. Corporate Bonds:** Moving down the risk spectrum in the Bond asset class are Corporate Bonds. These bonds are rated investment grade by at least one of the major ratings agencies (Moody's, Standard & Poor's, or Fitch). Corporate bonds tend to be a significant part of most bond portfolios as they have the potential to generate higher income and returns than Government Bonds. While the higher income can be attractive, it is important to balance this with the potential for higher volatility from this sub-asset class.
- **U.S. High Yield Bonds:** Generally High Yield bonds are Corporate Bonds rated below investment grade or not rated at all. In our view, these tend to be the riskiest part of the bond spectrum that we would consider incorporating into a portfolio. As part of any analysis of High Yield Bonds, it is important to consider the potential that the issuer defaults on their payments. Due to the higher risk of this occurring, these bonds tend to generate significantly higher income and potentially total return that most other areas of the bond market. We tend to view High Yield Bonds as more of an opportunistic piece to hold within a broader portfolio. This is because there are times where the potential returns outweigh the risks in this more speculative side of the bond market.

What we do not own or consider adding to portfolios in the Bond asset class are overly complex products. These tend to fall into the categories of derivatives, non-listed bonds, as well as international bonds.

The Stocks Asset Class

We view Stocks as the primary growth engine for most balanced portfolios

We view Stocks as the primary engine of growth for most balanced portfolios. As opposed to Bonds that generally only have a fixed amount of income and returns, the return potential from Stocks is nearly unlimited. Investors in a stock own a piece of equity in a company. This is why stocks are often referred to as "equities". This equity ownership is often priced on the amount of earnings generated per share. As the earnings for a company increase, or the expectation for earnings growth increases, the value of a company's equity also increases. During times of economic growth or a company's commercial success, it is not uncommon for earnings to grow at a rapid pace, translating to outsized returns for investors. Additionally, many of the large well-established companies also pay shareholders a dividend. These cashflows can be a secondary source of returns for investors. Of course, with the potential for outsized returns when times are good, the opposite is true during times of stress. While it is great to see a stock's price rapidly rise as earnings grow, stock prices can also come crashing down when earnings rapidly decline. This makes incorporating Stocks into a portfolio a careful balance of adding potential returns while not incorporating too much risk.

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Similar to Bonds, we break the very large Stock asset class into smaller sub-asset classes. This segmentation helps us to better identify specific investment opportunities, while staying focused in one of the broadest asset classes. These sub-asset classes are:

- **U.S. Large Cap Stocks:** These are the largest publicly traded companies in the United States. Often times when investors are referring to "the stock market" they are talking about this sub-asset class. Given the size of these companies, they often track global growth. Although riskier than bonds, we view this as the least risky sub-asset class across Stocks. It is important to note that many of these companies have operations outside of the United States. We tend to view these business lines as additional engines of growth that can further boost earnings for investors.
- **U.S. Small Cap Stocks:** Smaller companies in the United States that tend to be localized or regional businesses. These companies tend to follow the economic cycles of the U.S. Given their size, they tend to do very well during periods of economic growth and can have very challenging times during recessions. Although they have the potential for outsized returns, often the intense competition in their markets and/or smaller business footprints brings a higher risk that a misstep could lead to a bankruptcy. We see this as a specialized sub-asset class where seasoned portfolio managers have the potential to add significant value. Similar to the High Yield Bond sub-asset class, we see U.S. Small Cap Stocks as an opportunistic position for portfolios as opposed to a permanent one.

Within the Stock Asset Class, we focus on U.S. Large Cap Stocks, U.S. Small Cap Stocks, International Developed Stocks, and Emerging Markets Stocks

- **International Developed Stocks:** International Developed Stocks tend to be the largest non-U.S. based companies headquartered in developed countries. This group of countries is often referred to as Europe, Australasia, and the Far East or EAFE. Similar to U.S. Large Cap Stocks, this sub-asset class also tends to follow global growth. Additionally, by adding international companies in the developed world to a portfolio we incorporate other sources of potential returns as many of these companies do not have operations within the U.S. This, in turn, should help to diversify returns within the Stock asset class.
- **Emerging Markets Stocks:** Emerging Market Stocks combine the attributes of the International Developed Stocks and U.S. Small Cap Stocks sub-asset classes. They have the potential to provide

differentiated returns for investors as they often operate in markets outside of the United States. Additionally, given the developing nature of their economies, this sub-asset class is often associated with the riskiest corner of the Stock asset class. Fortunately, this sub-asset class tends to produce the some of the largest gains during periods of economic growth. As a result, this sub-asset class is generally a permanent allocation in most portfolios, although the weighting can change dramatically based on where we are in the economic cycle.

Outside of these four sub-asset classes are many others. We have found that although other areas can present unique opportunities from time to time, staying focused in these main four sub-asset classes tends to lead to consistent performance over time. Although the list of sub-asset classes that we have excluded is lengthy, some of the more common ones that we don't include are master limited partnerships or MLPs, real estate in the form of REITS, and mid-cap stocks. For MLPs, the complex tax nature of these investments make them less than ideal for most investors. For REITs and Mid-Cap stocks, we often see this exposure in many large cap strategies. As a result, to purposely allocate to these sub-asset classes would unintentionally overweight our exposures. Our preference is to give our large cap managers enough leniency to allocate to mid-caps and REITs as they see fit.

Cash

Cash can add value by increasing overall liquidity and reducing volatility for a portfolio

Rounding out our core set of asset classes is Cash. Cash is often an afterthought in the minds of most investors. This is because from a purely returns based perspective, there is relatively little value compared to Stocks and Bonds. Taking a broader perspective, cash can add value by increasing overall liquidity and reducing volatility for a portfolio. In our view, these factors can be nearly just as important as producing returns.

Liquidity is important for several reasons. First, investors risk their hard-earned savings in the markets with a goal of growing their savings over time. This is most commonly tied to the goal of providing income during retirement. Once investors are in the withdrawal or "decumulation" stage, having ample liquidity is important to support monthly distributions. If one has to consistently sell a piece of their investment portfolio every month to support these withdrawals, the results could be less than optimal. Additionally, liquidity is important when shifting between asset classes and investments. Since the world of investing is a mix of art and science, having at least a small level of liquidity in portfolios makes rebalances fluid. Lastly, there is always a cost to invest in the markets. Having liquidity in a portfolio helps to cover these costs without being forced to sell investments.

In addition to providing liquidity, cash can also reduce overall volatility for a portfolio. Since cash is the one asset class that will not go down[1], there is

[1] This is assuming that cash is held in an FDIC Insured or otherwise protected investment.

a certain level of comfort that comes with that trait. Going back to the comment about investors turning to the markets with a specific goal in mind, outside of retirement some of the other common goals are paying for college tuition for children or a vacation home. When the time horizon is long for these goals, investors can take on more risk as there is ample time to recover from losses in the near term. As the goal becomes closer, such as a child going to college, it is important to lower risk in a portfolio as there is less time to recover from losses. While allocating more to bonds during this time is prudent, Cash is another key asset class. Especially when the goal is nearly at hand, the stable nature of Cash can ensure that the gains created over years of prudent savings and investing are not lost just when they are needed.

The Other Asset Classes

We tend not to focus on Alternatives and Commodities as they are generally designed for those with different characteristics than the average investor

Outside of our core three asset classes, there are two others (Alternatives and Commodities) that round out the entire investment universe. We tend to not focus on these asset classes as they are generally designed for those with different characteristics than the average investor. This is because many of the investments in these asset classes are designed for investors with very long time horizons, low liquidity needs, or both. While it is important to understand what fits into these asset classes, we generally do not include them in our portfolios.

Alternatives

Alternatives are a very broad category that has turned into a catch-all for investments that don’t fit into any other asset class

Alternatives are a very broad category that has turned into a catch-all for investments that don’t fit into any other asset class. Within this asset class are the well-established sub-asset classes of Hedge Funds, Private Equity, Private Debt, and Private Real Estate. These investments almost always come with high minimums that can make them unapproachable for all but the largest of investors. Additionally, they also tend to have low liquidity and a limited ability to redeem your investment. Lastly, they also tend to have some of the highest fees in the universe of investments. As a result, these investments are generally reserved for qualified investors who have a portfolio that is sufficient to navigate these additional considerations.

In addition to the well-defined sub-asset classes of Alternatives, we also include more esoteric corners of the markets. These include emerging investment areas such as crypto currencies and non-fungible tokens (NFTs) as well as very complex products such as levered and inverse ETFs. For these types of investments, there is not enough history to be certain how they will perform in most market environments. While there may be some anecdotal stories of someone successfully investing in one of these sub-asset classes, there are plenty of others in which people lost their entire savings. As portfolio managers focused on growing your savings through carefully crafted portfolios, we don’t see these sub-asset classes as prudent additions to a portfolio.

Since commodities tend to not be a driver of returns, we prefer to use a combination of our core three asset classes to reduce volatility rather than increasing complexity with a fourth asset class

Commodities

The Commodities asset class rounds out the universe of potential investments. Commodities are the raw materials that go into most economies. These are often organized by soft commodities, or those that are grown, and hard commodities, or those mined from the earth. Commodities investments can be made broadly through the use of a fund or be focused in a single commodity such as gold or oil. In our view, commodities have historically been more of a contributor to portfolio stability than return. While from time to time a commodity may be exceptionally cheap, making it an attractive short term investment, their low return correlation to stocks and bonds are their true benefit. Unfortunately, investing in commodities is not a perfect science as often the mechanism to own commodities is costly. This often results in "slippage" so that the investment tends to underperform the commodity that it intended to track. Since commodities tend to not be a driver of returns, we prefer to use a combination of our core three asset classes to reduce volatility rather than increasing complexity with a fourth asset class.

By constructing portfolios with these core asset classes, investors should have a good understanding of what they own and how it will perform in different environments

Conclusion

Putting it all together, investing across the Stocks, Bonds, and Cash asset classes enables us to create balanced portfolios designed to deliver quality returns over a market cycle. By constructing portfolios with these core asset classes, investors should have a good understanding of what they own and how it will perform in different environments. Rely on your Gallagher financial planner to design an investment portfolio in which you are comfortable owning throughout a market cycle.

Summary of Asset and Sub-Asset Classes

Asset/Sub-Asset Class	Purpose
Cash	**Can insulate portfolio against short-term losses**
Bonds	**Tends to stabilize portfolios by reducing overall volatility, generally, negatively correlated to stocks**
U.S. Government Bonds	Source of income and volatility dampening
U.S. Investment Grade Corporate Bonds	Potential greater source of income and returns
U.S. High Yield Bonds	Opportunistically used when relative yields become attractive
Stocks	**Historically the return driver for portfolios, although tends to raise overall portfolio volatility**
U.S. Large Cap Stocks	Largest U.S. companies, which tend to be multi-nationals
U.S. Small Cap Stocks	Smaller U.S. companies that tend to be closely tied to U.S. economic growth
Developed International Stocks	Provides geographic diversification to equity exposure
Emerging Markets Stocks	Can be a source of outsized returns, albeit at high levels of risk

Risks and Disclosures

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Asset class risks

Bonds: are subject to market, interest rate and credit risk; and are subject to availability and market conditions. Generally, the higher the interest rate the greater the risk. Bond values will decline as interest rates rise. Government bonds are subject to federal taxes. Municipal bond interest may be subject to the alternative minimum tax; other state and local taxes may apply. High yield bonds, also known as "junk bonds" are subject to additional risks such as the increased risk of default. Debt securities may be subject to call features or other redemption features, such as sinking funds, and may be redeemed in whole or in part before maturity. These occurrences may affect yield. Like all bonds, corporate bonds tend to rise in value when interest rates fall, and they fall in value when interest rates rise. The longer the maturity of the bond, the greater the degree of price volatility. If you hold a bond until maturity, you may be less concerned about these price fluctuations (which are known as interest rate risk or market risk), because you will receive the par or face value of your bond at maturity.

Stocks of Large Growth and Value Companies: Portfolios that emphasize large and established U.S. companies may involve price fluctuations as stock market conditions change.

Stocks of Small- and Mid-Capitalization Companies: Tend to involve more risk than stocks of larger companies. Investments in small- and mid-sized corporations are more vulnerable to financial risks and other risks than larger corporations and may involve a higher degree of price volatility than investments in the general equity markets.

International/Global Investing/Emerging Markets: International investing may not be suitable for every investor and is subject to additional risks, including currency fluctuations, political factors, withholding, lack of liquidity, the absence of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be magnified in emerging markets.

Commodities: Commodities are assets that have tangible properties, such as oil, metals, and agricultural products. An investment in commodities may not be suitable for all investors. Commodities may be affected by overall market movements and other factors that affect the value of a particular industry or commodity, such as weather, disease, embargoes, or political and regulatory developments. Commodities are volatile investments and should only form a small part of a diversified portfolio. Diversification does not ensure against loss. Consult your investment representative to help you determine whether a commodity investment is right for you. Market distortion and disruptions have an impact on commodity performance and may impact the performance and values of products linked to commodities or related commodity indices. The levels, values or prices of commodities can fluctuate widely due to supply and demand disruptions in major producing or consuming regions.

Inflation: is measured by the year-over-year change for the Consumer Price Index or "CPI". This index represents the changes in the prices of all goods and services purchased for consumption by urban households. User fees (such as water and sewer) and sales and excise taxes paid by consumers are also included.