

# Financial Market ViewPoints

## Understanding Risk Across Your Investment Portfolio

*Accounting for potential concerns and constructing an investment portfolio with a tolerable level of risk is the one of the main goals of good portfolio management.*

*As part your conversation around risk, other important aspects should be addressed such as time horizon, income needs, and investment experience.*

If you ask 100 people to define risk, you will probably hear nearly 100 different definitions. Risk can mean different things to each person as their definitions of investment risk often include a number of potential pitfalls that make investments less than guaranteed. Accounting for these potential concerns and constructing an investment portfolio with a tolerable level of these “risks” is one of the main goals of your investment team.

The first step in creating an investment approach that follows what you find as acceptable risk is to understand some of the more common risks in the investment markets. At its most simplistic level, we often refer to risk as the possibility of experiencing a loss in value. This is generally the result of either company specific issues or concerns that are impacting the broader market.

To further refine risk, we prefer to focus on the size and frequency of price movements for an investment. Generally, if price movements increase, the chance of loss also increases. This, in turn, tends to raise the overall risk within one’s portfolio. This is often referred to as “volatility” and is a measurable gauge that is useful in calibrating a portfolio to each person’s acceptable level of risk, or risk tolerance.

It is important to match the risk in each investor’s portfolio with their risk profile. If there is a mismatch, the investor will either be frustrated with lower returns than they were expecting due to a portfolio with too little risk or will be frequently concerned about losses if the risk level is too high. This is why often the first step in selecting an investment portfolio starts with a risk assessment. Since risk for an individual does truly need to be calculated on an individual basis, it is nearly impossible to simply select a specific portfolio without having taken a risk assessment or having a conversation with your financial planner.

As part of an assessment or conversation around risk, other important aspects of your investment goals should also be addressed. While the full list of these inputs is lengthy, our top three additional factors are time horizon, income needs, and investment experience. Each of these factors can lead to a significant shift in risk within one’s portfolio. For example, if someone has a higher tolerance for risk, one would generally look for a portfolio with high potential returns as risk is less of a concern. If this same client had a short investment time horizon, it may be prudent to implement a portfolio with somewhat lower risk as there is a shorter period of time to recoup losses following a period of declines.

Generally, risk tolerances are “bucketed” into five groups to help quantify potential levels of risk and returns.

With all the investment solutions available to investors today, there are virtually a limitless set of combinations to craft an appropriate portfolio. Traditionally, many investment firms have taken a “bucketing” approach to simplify these options. Generally, these buckets fall into five areas that range from the least risky (often referred to as “Preservation” or “Conservative” depending on each firm’s naming convention) to the riskiest (generally appropriately called “Aggressive” at most firms). The table below lists the five risk profiles that we use in creating our investment solutions for clients. Additionally, we added a second row that follows an alternate naming convention that is also commonly used for risk profile strategies.

### Continuum of Risk Profiles

Preservation	Conservative	Moderate	Growth	Aggressive
Conservative	Moderately Conservative	Moderate	Moderately Aggressive	Aggressive



**Least Risk**

**Most Risk**

Now that risks have been discussed, your risk tolerance has been determined, and your risk profile has been identified, it’s time to talk about returns. For most investors, risking their hard earned savings in the markets is a careful balance between potential gains and losses. Although minimizing risk is always important, without an acceptable level of gains, the results can be frustrating. For this reason, we have designed our five risk profiles to follow certain return goals over the long term. While at any given year portfolios may produce dramatically different returns, over a full market cycle they are designed to meet their return bogeys. These risk profiles are:

#### **Preservation: 5% Return Target**

Model portfolios in the Preservation “Bucket” are designed to do just that – preserve capital. To that end, it is important to generate sufficient returns to overcome the bite of inflation as well as the cost of investing. Ultimately, these solutions are designed to maintain purchasing power through producing relatively stable and modest growth. To achieve this objective, portfolios tend to rely heavily on bonds to provide both stable returns and soften the impact when the stock side of the portfolio declines.

#### **Conservative: 6% Return Target**

Conservative portfolios are similar to their Preservation “neighbor”, with the exception that they are intended to generate a modest level of “real” growth of approximately 1% per year over the long-term. What this means to us is that if a Preservation portfolio is designed to maintain the value of your assets after the impact of inflation and fees, Conservative portfolios are designed to generate a small return above this threshold. This is achieved

with a higher allocation to stocks, as they generally tend to generate higher returns than bonds. Although these strategies are on the lower end of our risk spectrum, the additional exposure to stocks would lead to higher levels of price swings compared to a Preservation portfolio during market selloffs.

### **Moderate: 7% Return Target**

Moderate portfolios are designed for the “middle of the road” investor who is looking for prudent growth, while minimizing exposure during declining markets. These are the classic “60/40” portfolios often referred to in the media and investment strategists. By constructing a portfolio that is roughly 60% stocks and 40% bonds, the conventional view is that there is sufficient exposure to stocks to generate meaningful returns over the long term, while also having enough exposure to bonds to deaden the pain of being invested through a bear market for stocks.

### **Growth: 8% Return Target**

Growth portfolios are at the start of the riskier end of the continuum. They tend to be heavily focused on stocks, and as a result their volatility is much similar to that of investing in the stock market. Bonds are used in these strategies to provide a modest benefit when stocks decline as well as produce income that could be used to meet potential withdrawal needs from the portfolio. Investors in this bucket tend to have a longer time horizon and are willing to accept the higher levels of volatility associated in exchange for the potential of higher overall returns.

### **Aggressive: 10% Return Target**

Aggressive portfolios are designed for investors looking to capture the long-term returns of the stock market. While these portfolios may opportunistically use bonds from time to time, they are generally fully invested in stocks. Investors in this bucket almost always have a long-time horizon and generally little liquidity needs. This tends to position them well to “weather” periods of higher volatility as they generally should expect to see multiple bull and bear markets over their investment horizon.

Putting it together, as investors, it is important to balance risk with your return objective. From our perspective, we prefer to start most risk conversations with return objectives. In our view, it is much easier to tie an overall return objective for one’s portfolio into an analysis of one’s future spending needs. From there, discussing the level of risks and types of risks associated with that return objective help to clarify the range of potential returns as well as important considerations that may impact one’s portfolio. Ultimately the conversation of risk is very personal, be sure to meet with your financial planner to discuss how your risk tolerance level impacts your financial goals and objectives.

*We prefer to start most risk conversations with return objectives as it tends to be easier for investors to identify than an acceptable level of risk.*

### Summary Table of Risk Profiles

Risk Profile	Attributes	Target Return*
<b>Preservation</b>	<ul style="list-style-type: none"> <li>• Designed for investors focused on capital preservation</li> <li>• Seeks to maintain inflation-adjusted value over the long-term</li> <li>• Predominant allocation to fixed income</li> </ul>	<b>5%</b>
<b>Conservative</b>	<ul style="list-style-type: none"> <li>• Designed for investors seeking minimal capital appreciation</li> <li>• Seeks to nominally grow assets beyond inflation over the long-term</li> <li>• Preference towards fixed income</li> </ul>	<b>6%</b>
<b>Moderate</b>	<ul style="list-style-type: none"> <li>• Designed for investors focused on total return</li> <li>• Seeks to balance capital appreciation and preservation</li> <li>• Balanced allocation to equities, fixed income, and cash</li> </ul>	<b>7%</b>
<b>Growth</b>	<ul style="list-style-type: none"> <li>• Designed for investors seeking capital appreciation</li> <li>• Seeks to generate near equity returns with lower volatility</li> <li>• Preference toward equity assets</li> </ul>	<b>8%</b>
<b>Aggressive</b>	<ul style="list-style-type: none"> <li>• Designed for investors seeking equity market returns</li> <li>• Seeks to outperform the equity markets over the long-term</li> <li>• Allocation among the equity sub-asset classes</li> </ul>	<b>10%</b>

\*Target Return is the long-term return objective that is measured by the annualized return over a full market cycle.

## 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.

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