With the start of a new year, we thought it would be a good time to revisit the topic of asset allocation and diversification. While these topics are similar, there are some key differences. In this article, we will first define these terms. We will then guide you in determining if your asset allocation and diversification level are appropriate.

Asset allocation refers to how capital is divided among different asset classes. The most common asset classes we see used are stocks, bonds, and cash. There are some less common, but worth mentioning, asset classes like: hedge funds, private equity, commodities, preferred stock, precious metals, and crypto assets. The key thing to take away from these lists is, each item has different characteristics that define them. Since we lack time to define this list in its entirety, we will be focusing on stocks, bonds, and cash. However, if you have questions on any of the other asset classes, please contact your Surevest advisor and they will be happy to coach you.

Let’s start with the easiest asset class, cash! Cash can be thought of as funds in a checking, savings, money market, physical dollar bills, etc. While cash under your mattress is technically an asset class, we recommend placing it somewhere safe, where it can earn interest. As you are probably already aware of, bank accounts and money market accounts do not typically pay the highest rates of return. However, the defining factor of this asset class is its liquidity and means of exchange for goods and services. While cash typically has low returns, it does not have negative returns. However, once you factor inflation in, you will very likely see negative returns. In order to avoid this, you will need to invest your cash in other asset classes.

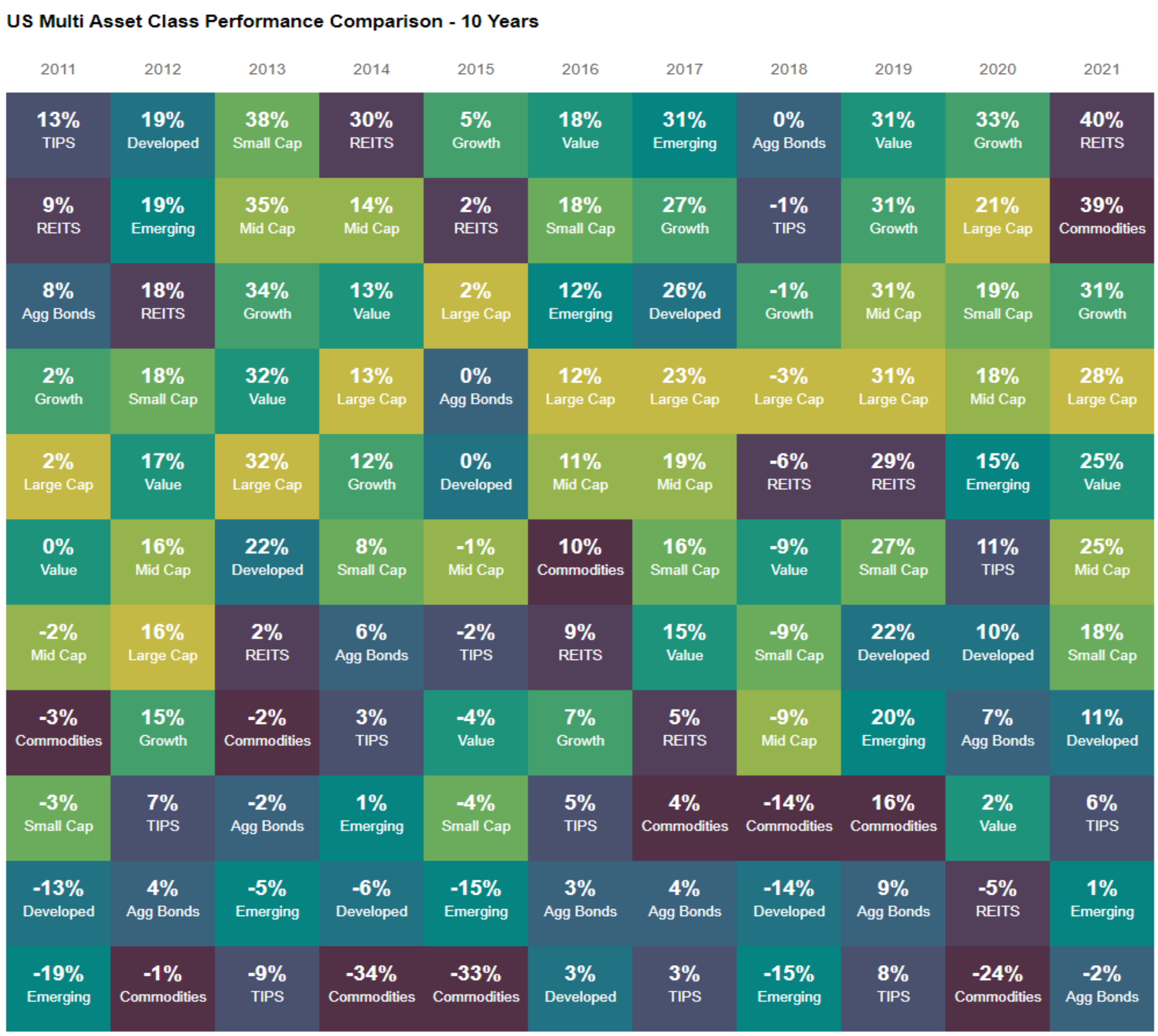
The next safest place to invest cash is bonds. Bonds represent a loan from the investor to the issuer. The issuer has promised to return the principal with interest to the investor. Similar to you borrowing from a bank with the promise to pay them back. The bank will charge you interest on your loan similar to how a bond issuer pays interest to the investor. The interest required by investors will depend on a variety of things like credit quality (how likely are you to get your money back), inflation rate, length of the loan(maturity), etc. One of the most important things a bond investor should expect is repayment of principal, followed by a return that maintains spending power. i.e., keeps pace with inflation. Any return beyond the inflation rate would be considered a positive **real return.** Put differently, real return is the return generated that exceeds the inflation rate.

Now let’s take a brief look at what a stock is. A share of stock represents ownership or equity in the underlying company. This ownership entitles the stockholder to the profits generated by the company. The most common form companies use to distribute these profits to shareholders are dividends and share buybacks. Dividends put cash directly in the hands of the stockholders while share buybacks add value by decreasing the number of shares available. By decreasing the number of available shares, the shares that are still trading should become more valuable. Companies typically do share buybacks as a way of returning cash to shareholders without triggering taxes. Additionally, as the owner of a company you have certain rights. Some of these include voting on important company decisions like M&A (mergers and acquisitions), board of directors, corporate charter amendments, etc.

As you can see, each of these asset classes have a set of unique characteristics that define them. Because of the uniqueness we also expect different levels of risk and return to be associated with each asset class. But that’s a topic for another article. Let’s talk about diversification instead.

Diversification can be thought of as how spread out your money is among different investments within each asset class. There are many ways to define diversification and some examples of ways to look at equity diversification are number of holdings, sector/industry, company size, growth/value. The number of holdings is an important area of concern. This is because we often hear clients think they need many holdings to be properly diversified. While increasing the number of holdings can certainly help, adding ten new large-cap tech stocks to an already tech heavy portfolio will not help to increase your diversification. This is because companies with similar characteristics tend to trade together. i.e., large companies will trade more similar to other large companies, than they do to small companies. The same will hold true for growth companies' vs value companies. The more characteristics two stocks have in common, the more likely they are to trade in tandem. This same concept also applies to investment within other asset classes.

Now let's try tying this all together. You can think of the first step of asset allocation as determining which asset classes we want to use and in what proportions. This will be the first step in determining a portfolios risk and return levels. The next step is how diversified do you want to be within each asset class? Is three bonds and five stocks going to be enough to claim you are diversified, probably not. Each asset class and even various subgroups within asset classes tend to perform differently over time. This is where the often-heard phrase 'diversification is the only free lunch' comes from. To help bring this home, we placed a quilt chart showing various returns for different asset classes and withing asset class groupings below.



The point is that regardless of how strong anyone's conviction is on their market outlook; it is impossible to know in advanced which asset class will perform better each year. You can reference the quilt to see that in some years small cap stocks do better than large cap stocks, but in other years, it is the complete opposite, like what we saw in 2021. That is why your investment team at Surevest begins with designing the proper asset allocation and builds globally diversified portfolios for our clients. If the best performing asset class is not in the portfolio, that could cause underperformance relative to a well-diversified benchmark.