



Asset Allocation: Your Critical Investment Decision

DISCIPLINE, CAPABILITY AND PROCESS TO CREATE A LASTING PLAN FOR HONORING PROMISES

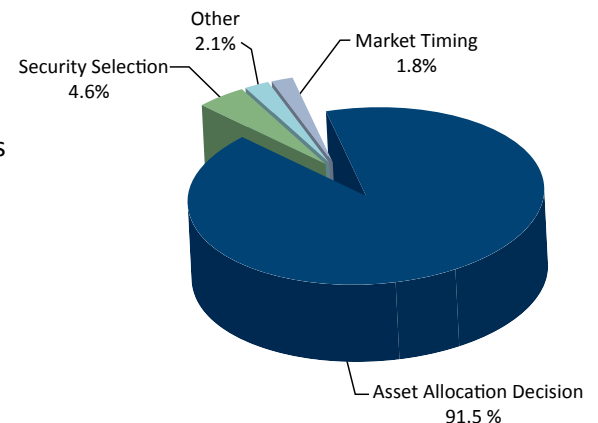
Despite what you might read in the popular financial media, choosing the “best-performing” investments does not always translate into success within an investment program designed to meet long-term financial needs and wishes. Unfortunately, many investors rely on shortcuts such as “star” ratings or performance rankings when developing their plans for investing, only to find themselves disappointed in their choice before chasing another “hot” investment. One of the most important investment decisions you can make is to clearly define, and put in writing, your investor profile before starting any investment program. Working with a trusted advisor to define and document your profile and then matching it to an appropriate portfolio of investments properly diversified across a mix of asset classes is the best way to start. The efficient allocation of your investments among various investment asset classes is the first step to achieving your long-term financial objectives. By adopting and documenting an asset allocation that matches your unique profile, you create a blueprint for your future investment decisions, creating a kind of benchmark or guide that can counter emotional factors like fear and greed.

What is asset allocation?

Asset allocation is the process of choosing among possible asset classes in investing. A large part of developing an investment plan consists of finding an asset allocation that is appropriate for you in terms of both your appetite and ability for bearing risk. When performed correctly, the selection and weighting of asset classes will reduce the “volatility,” or variability of returns, that a portfolio experiences. This is accomplished by diversifying across a variety of investments, such as domestic and international stocks, bonds, real estate and commodities, whose returns do not necessarily move in sync. Asset allocation is effective when the asset classes selected are unlikely to generate similar returns at the same time.

Why is asset allocation so important?

In the 1980s and 1990s, research was conducted on the investment strategies of nearly one hundred large corporate pension plans. The famous studies by Brinson, Singer and Beebower concluded that the decision of what asset classes to use and in what weighting (asset allocation) was the “overwhelming factor in determining the basic, long-term return achieved per unit of risk (volatility).”¹ The studies reinforce the assertion that the asset allocation decision has more impact than either the selection of individual securities or the timing of buys and sells.



Source: Brinson, Singer & Beebower, 1991

How does asset allocation work?

We can see the effect of asset allocation on the volatility of portfolios in pictures. Let’s look at the performance of two hypothetical accounts, as illustrated in the graph on the next page, over a one-year period. In our first account, we’ll envision that we take on a typical asset allocation decision and invest \$20,000 divided equally between a highly volatile investment (red line) that goes up and down significantly and an investment that goes up and down less. In our example, the volatile investment goes up 12 percent one month before going down 8 percent the next month, and the other investment (blue line) goes up and down half as much (up 6 percent one month and down 4 percent the next). In this example, when our volatile investment goes up, our steadier investment also goes up, but only half as much. Conversely, when our volatile investment goes down, our steadier investment goes down only half as much. From the graph, we can see the green wavy line grows about 15 percent to a little more than \$23,000—not bad, but a bumpy ride. Investors often use a shortcut and focus only on the 15 percent return number and pay little heed to the accompanying volatility that comes with a potential 15 percent return. At the bottom of a wave, investors often recognize a “losing position,” when they get scared and sell out of the investment.

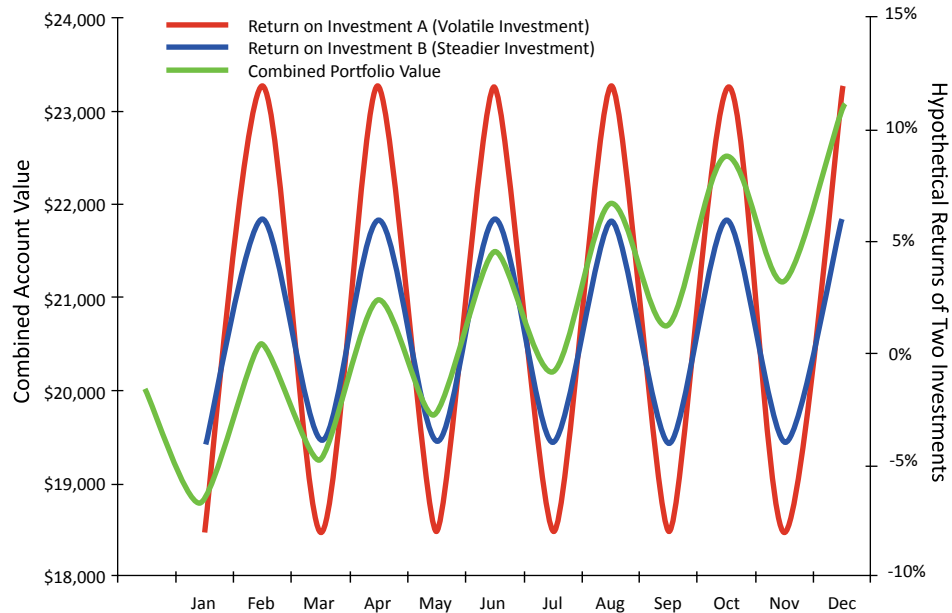
¹ Brinson, Gary P., Brian D. Singer and Gilbert L. Beebower. “Determinants of Portfolio Performance II: An Update.” Financial Analysts Journal May-June 1991: 40-48.

In our second hypothetical portfolio, we'll look at the impact of a vital component of efficient asset allocation, a statistical concept called **"correlation."** Correlation measures the rate at which the movement of one variable is related to the movement of another. In our case above, every time our risky asset went up, our not-as-risky asset went up, and every time our risky asset went down, our not-as-risky asset did the same. This is called **positive correlation**. What would our second account look like if our two assets had **negative correlation**? This would mean that every time our risky asset went up, our steadier asset went down, and every time our risky asset went down, our steadier asset went up.

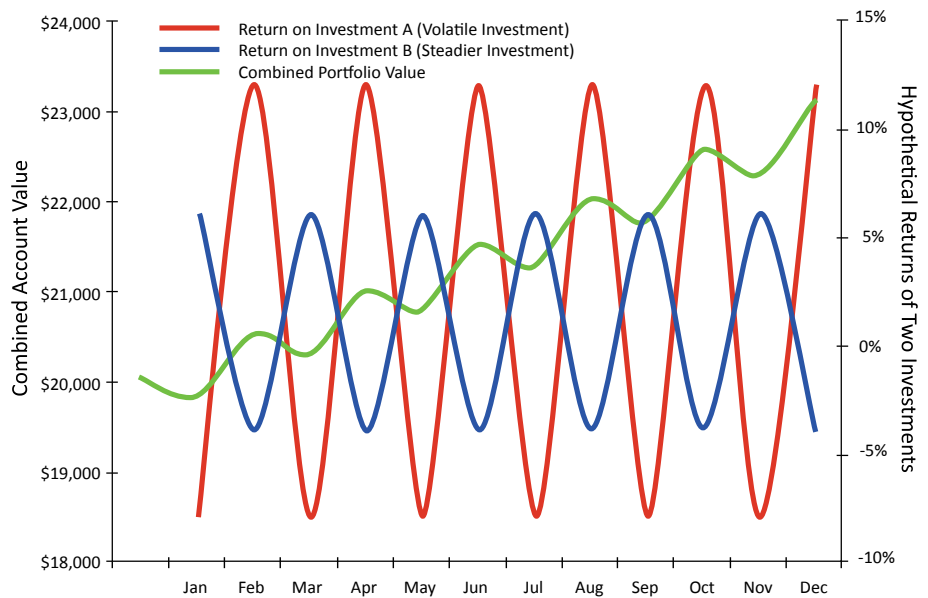
As you can see from the graph to the right, we still end up with the same 15 percent return and an account value of a little more than \$23,000. However, since our investments had negative correlation, the green line is smoothed out quite a bit. The principle of correlation is extremely important in creating a well-diversified portfolio. A basket of investments that perform similarly does not provide as much benefit, especially emotionally, as diversification across investments that perform somewhat differently.

In reality, assets don't have the type of perfect correlations represented in these graphs, but the degree to which assets are positively or negatively correlated is an important component in applying asset allocation principles to a portfolio.

Asset allocation and diversification do not guarantee a profit nor do they eliminate the risk of loss of principal. There is no guarantee that any investment strategy will be successful.



This graph represents the one year performance of an account comprised of two hypothetical investments with positive correlation. This chart is shown for illustrative purposes only and is not intended to predict or depict the returns of any particular investment. Past performance does not guarantee future results.



This graph represents the one year performance of an account comprised of two hypothetical investments with negative correlation. This chart is shown for illustrative purposes only and is not intended to predict or depict the returns of any particular investment. Past performance does not guarantee future results.

The Impact of Asset Allocation on Investor Behavior

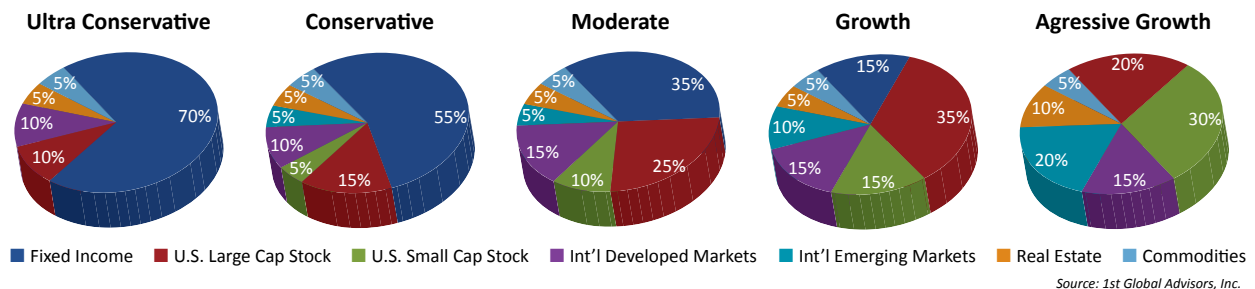
One of the biggest challenges you may face in achieving your long-term investing objectives is taming your own emotions. Look back to the first chart of our positively correlated securities. How would you react when your portfolio was on one of the downward-sloping lines? Would you react differently to one of the downward-sloping lines on the second chart?

Many investors, reacting to emotions, feel compelled to make changes to a more volatile portfolio like our first one, and are more comfortable managing emotions with a less volatile portfolio, like the second. If smoother returns help you stay the course and stick with your investment program, and both accounts end up in the same place, is there is a tangible benefit to choosing a portfolio with reduced volatility? We believe the answer is yes.

Investors often accept the principle of “asset allocation” and then make the error of focusing on the performance of individual asset classes, especially those that are more volatile or less correlated and designed to enhance returns and to reduce portfolio volatility. This microscopic and segmented approach to portfolio analysis causes some investors to abandon their overall asset allocation plan in favor of choosing only “hot” investments. This is always a mistake. The best practice is to seek investments that exhibit low correlations and, by doing so, perform differently at different times.

1st Global’s Investment Philosophy

The principles of multi-asset class diversification, and the benefits of asset allocation, are the foundation for 1st Global’s investment philosophy. In 2010, 1st Global began consulting with Dr. Harry Markowitz, a pioneer in the field of investment portfolio construction, to review and validate 1st Global’s asset allocation models. The outcome of this extensive review reinforced 1st Global’s commitment to providing sound investment guidance based firmly on academic research.

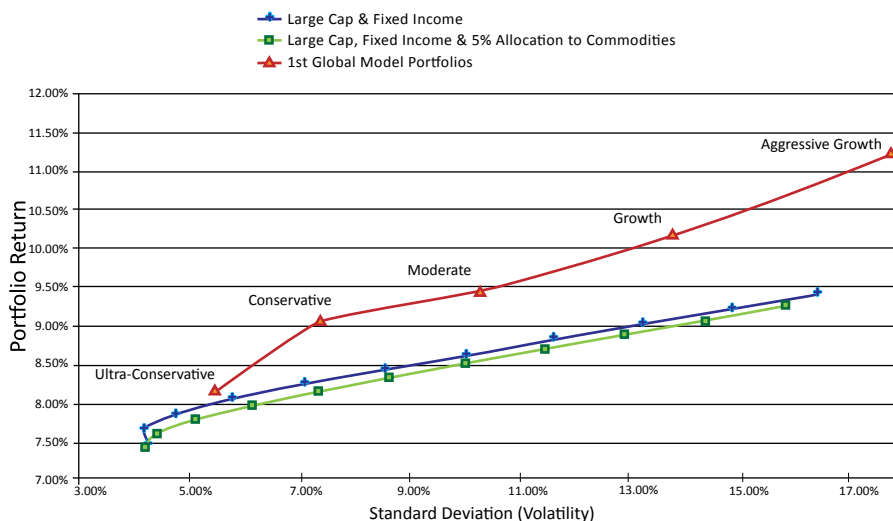


1st Global’s asset allocation models utilize seven core asset classes: Fixed Income (bonds), U.S. Large Cap Stock, U.S. Small Cap Stock, International Developed Markets Stock, International Emerging Markets Stock, Real Estate and Commodities. The embodiment of the 1st Global philosophy of appropriate diversification through a disciplined asset allocation are the five model portfolios composed of various blends of seven asset classes². Each model portfolio exhibits a different expected rate of return along with a commensurate level of volatility (risk).

² 1st Global’s investment philosophy white paper, “The Efficient Diversification of Multi-Asset Class Portfolios: A User’s Guide to Strategic Investing,” describes the process behind the construction of these portfolios and is available from your 1st Global Financial Advisor.

1st Global’s asset allocation models are designed to provide efficient diversification and maximize expected return per unit of risk taken. When selecting individual investments, investors are “compensated” for accepting a greater risk of loss by larger potential returns. For this reason, an increase in expected volatility goes hand in hand with an expectation of the potential for a larger return. Since we know that diversification can reduce overall portfolio risk, we can add “riskier” assets that carry a greater potential for higher returns. While in isolation individual investments or asset classes may bear risk higher than our comfort level, by combining these assets with others having differing correlations, we can reduce risk, yet still have the potential for higher returns from the riskier assets.

Data from 1/1988 - 9/2010



This graph represents the return and volatility (standard deviation) of three combinations, a mix of two asset classes, U.S. Large Cap Equity and Fixed Income, three asset classes, U.S. Large Cap Equity, Fixed Income and Commodities, and the 1st Global model portfolios as represented by the S&P 500 Index, Barclays Capital Aggregate Bond Index, S&P GSCI, Ibbotson Small Company Index, MSCI EAFE Index, MSCI Emerging Markets Index and the FTSE NAREIT Equity REIT Index. This chart is shown for illustrative purposes only and is not intended to depict or predict the returns of any particular investment. Past performance does not guarantee future results.

Conclusion

In a world where investors are bombarded by new information offering the “best” funds or the most recent “hot” investment strategy, multi-asset class asset allocation almost seems plain and unexciting. In 1990, however, this approach to rational and consistent investing won Dr. Markowitz a share of the Nobel Prize in Economic Sciences. In the nearly 60 years since Dr. Markowitz wrote his first paper on the subject of balancing risk and return in an investment portfolio, the implications of this original study continue to be applicable in asset management. Efficient asset allocation, and not picking the “hot” or “best” investment product, plays a huge role in determining the road to be traveled and the destination of one’s long-term financial goals. As an investor, you increase your chances of achieving your long-term goals by adhering to your asset allocation strategy. However, along the way, it is important to understand that your portfolio will be volatile over short-term periods, and that for diversification to truly work, components of your portfolio will likely underperform and outperform at various times relative to other components of the same portfolio.

Delivering multi-asset class diversification through model portfolios offers a framework for you and your financial advisor to make rational investment decisions without fear or greed, and offer a baseline against which you can review progress toward long-term investment goals. With the help of a trusted 1st Global wealth management advisor, you can define and document your investor profile (risk and time horizon) and choose a portfolio that meets your requirements for both returns and volatility.



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Barclays Capital U.S. Aggregate Bond Index is a broad based fixed-income securities benchmark. The index covers the U.S. investment-grade fixed-rate bond market, including components for U.S. Treasuries, government-related securities, corporate securities, residential mortgage pass-through securities, commercial mortgage-backed securities and asset-backed securities.

The S&P 500[®] Index is a free-float market capitalization index of 500 large publicly held U.S.-based companies, capturing 75 percent coverage of U.S. equities. It is often used as a proxy for the American stock market.

The Ibbotson Associates Small Company Stock Index is made up of the smallest 20 percent of capitalization of publicly traded stocks within the NYSE universe.

The MSCI EAFE Index (Europe, Australasia, Far East) is a free-float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. As of May 27, 2010, the MSCI EAFE Index consisted of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

The MSCI Emerging Markets (EM) Index is a free-float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of May 27, 2010, the MSCI Emerging Markets Index consisted of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey.

The FTSE NAREIT Equity REITs Index includes all equity REITs trading on the NYSE Euronext and the NASDAQ OMX. Equity REITs are defined as those firms that own, manage and lease investment-grade commercial real estate. Specifically, a company is classified as an equity REIT if 75 percent or more of its gross invested book assets is invested in real property.

The S&P GSCI[®] is a world-production-weighted index based on the average quantity of production of each commodity in the index over the last five years of available data. It provides investors with a reliable and publicly available benchmark for investment performance in the commodity markets and is comprised of the principal physical commodities that are the subject of active, liquid futures markets.

S&P 500[®] and S&P GSCI[®] are registered trademarks of Standard & Poor's Financial Services LLC.

The indexes illustrated in this paper are unmanaged indexes of common stocks, bonds or other securities. The volatility of the indexes may be materially different from the individual performance attained by a specific investor. In addition, the investor's holdings may differ significantly from the securities that comprise the indexes. The indexes are disclosed to allow for comparison of the investor's performance to that of certain well-known and widely recognized benchmarks of investment performance. It is not possible to invest directly in an unmanaged index.

Standard Deviation: A statistical measurement that sheds light on historical volatility of the returns of a fund or portfolio around its mean return during a given period of time. A higher standard deviation indicates higher volatility and, hence, an enhanced risk of a negative outcome.



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Emerging Market Stocks: Involve greater risk than investing in more established foreign market stocks. Such risks include currency exchange rates, political and economic upheaval, the lack of information about companies, low market liquidity, and differences in financial and accounting standards.

High-Yield Bonds: Have a greater risk of price fluctuation and loss of principal and income when compared to U.S. government securities such as U.S. Treasury bonds and bills, which offer a guarantee of repayment of principal and interest if held to maturity.

International Stocks: Additional investing risks include fluctuations in the value of the U.S. dollar relative to the values of other currencies, custody arrangements made for foreign holdings, political risks, differences in accounting procedures and the amount of public information disclosed by non-U.S. exchange-listed companies.

Micro Cap Stocks: May involve risks not associated with investing in more established companies. These stocks may be more volatile because they may be less liquid or financially secure and their product lines are not as diverse. Micro cap stock investments can be highly speculative.

Neither asset allocation nor diversification assure a profit or protect against a loss in declining markets.

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