Locust Capital Management's Investment Process

Asset Allocation

In the previous Locust Capital Investment Process newsletter we discussed the goals of investment management and how crucial it is to reduce risk in our clients' portfolios. In this newsletter we will discuss the key to reducing risk in a portfolio, namely the creation of an effective asset allocation plan.

Introduced in 1952, Modern Portfolio Theory serves as the basis for how modern managers invest their client's assets. Endowments, foundations, and pension plans of today (as well as Locust Capital Management) allocate their funds according to principles explored by Harry Markowitz and his Nobel Prize winning theory. Central to Markowitz' model is the simple understanding that the goal of investment management is to reduce risk while also maintaining the expected return of a portfolio.

Markowitz found that the most effective way to do this is to invest in a diversified set of investments. By diversifying into many different asset classes with dissimilar expected return, risk, standard deviation, and correlation characteristics it is possible to create an overall portfolio which contains a more attractive risk/return tradeoff than by investing in any one security. By combining assets with dissimilar characteristics it is possible to create a portfolio that reduces risk while also maintaining a healthy expected return.

Key to the principle of diversification is that the investments cannot be highly correlated. Owning an ETF that tracks the S&P 500 Index and attempting to diversify with and ETF that tracks the Russell 1000 is not going to reduce your risk since the two indices behave similarly. You would be better off investing in an asset that is negatively correlated to Large Cap Stocks (in this case a negative is a positive!), for example the Barclays Aggregate Bond Index. Ideally you can purchase assets that have prices which move in opposite directions under similar market conditions. Then, if the price of the S&P 500 Index was to suddenly fall, in those same market conditions the price of the Bond Index will rise (though this is not always the case). Investing in

assets not highly correlated to each other will help to reduce volatility in your portfolio and over time will increase the expected return of your portfolio.

One big detractor of long term portfolio performance is unnecessary volatility. As an example, if Investors A and B both have $100 and A invests for 3 years with the following returns, +5%, -10%, and +20%, A has an arithmetic average return of 5%. If Investor B invests for 3 years and has portfolio returns of +4%, +3%, and +8%, B also has an arithmetic average return of 5%. However, at the end of year 3 Investor A only has $113.40 while Investor B has $115.69. Investor B has outperformed Investor A by 2.3% over the 3 year period. This example displays the drastic impact volatility can have on long term portfolio returns.

While an efficient asset allocation is important, your investment plan has to be tailored to your goals. There is a risk and return tradeoff that one has to fully understand in order to properly choose a portfolio allocation. Achieving higher growth generally means taking more risk (by investing a larger proportion of assets into riskier asset classes) and a more stable portfolio (comprised mainly of less risky assets) will often not generate high returns. If you are just getting started with your savings it might not be appropriate for you to have 70% of your investments in bonds and you may want to seek more capital appreciation with an aggressive equity driven portfolio. However, if you are retired and living off of your portfolio's income stream it may very well be a good strategy for you to implement a more bond heavy portfolio. Based upon your objectives it is important that you employ a proper asset allocation which addresses your specific goals. Every client is unique and Locust Capital does not believe in cookie-cutter solutions, therefore no two clients' portfolios will be exactly the same.

We hope that this discussion has led to an increased understanding of the importance of asset allocation and Locust Capital's approach. We look forward to sharing with you our next piece on Investment Management, Manager Selection. Should you have any questions or want to discuss your personal situation in depth please do not hesitate to give us a call.

Sincerely,

-Locust Capital Management