Investment Methodology

White Paper

Our Investment Process

A critical component of your experience with our firm is the formation of a robust investment plan to guide you and us as we build and maintain your portfolio. In this supporting white paper, we discuss our methodology for helping you pursue your goals. Our broad process consists of five steps:

Step One: Assessing your goals and circumstances.

The investment planning process begins during the LifeDiscovery meeting with a discussion of your financial values and goals, key relationships, existing assets, other professional advisors, preferred process and important interests. Discovery will be an ongoing part of our relationship with you.

Step Two: Risk assessment.

Before recommending a particular portfolio strategy, we help you assess your ability, willingness and need to take risk as well as your comfort owning a portfolio that will behave differently from the U.S. stock market.

Step Three: Understanding the investment strategy.

We want you to understand our investment philosophy. We practice “Evidence-Based Investing” (EBI) which we will discuss in greater detail in this white paper.

Step Four: Building your portfolio.

Once we have completed discovery, helped you assess various aspects of risk and explained our approach to investing, we will implement your investment portfolio. Portfolios are typically composed of U.S., international and emerging markets stock funds; high-quality bonds held individually or through bond funds; and, in some cases, alternative investment strategies, which we will discuss in more detail. As part of implementation, we will focus on proper asset location, which is the process of locating tax-inefficient asset classes in tax-advantaged accounts like IRAs, Roth IRAs and 401(k) accounts.

Step Five: Ongoing maintenance.

After the portfolio is implemented, we will periodically rebalance the portfolio to ensure the asset allocation remains close to the one agreed upon. In addition, through periodic meetings we will make sure that we continue to understand all aspects of your life, in particular being sensitive to whether your investment goals and objectives have changed from the original implementation of the portfolio.

Step One: Assessing Your Goals and Circumstances

Long-term investment success means different things to different people. The best investment plan for you depends on your specific circumstances and objectives. That is why we begin the investment planning process in the LifeDiscovery meeting with a conversation about your values, goals, relationships, assets, types of accounts, advisors, preferred processes and interests.

While everyone's situation is unique, certain factors should be considered in creating any investment plan. These factors include the purpose of the portfolio, its size, specific funding sources, how and when you plan to use the funds, and the degree of uncertainty or risk you are willing to accept in pursuit of your objectives. As we establish a clear vision of your goals and circumstances, together we can build the foundation of an investment plan that best matches your needs as well as the realities of the financial markets.

Step Two: Risk Assessment

For many investors, their most important long-term goal is achieving financial independence. But most of us also have intermediate-term goals, such as funding college education, travel or vacation homes. Achieving these goals commonly requires some measure of risk since most investors need returns in excess of inflation to meet their goals. Risk, however, is multifaceted, which is why we focus on four different aspects of risk in helping guide the asset allocation discussion.

Part One: Ability to Take Risk

Your ability to take risk is most commonly a function of (1) the time horizon(s) of your investment objective(s), (2) whether you are working or retired, and (3) the stability of your job. Longer time horizons argue for more aggressive asset allocation strategies since a long time horizon gives the portfolio more time to recover after periods of poor performance. If you are still working, you may be able to be more aggressive since the portfolio is likely not needed to support spending needs. Investors in more stable jobs (e.g., a university professor) generally have greater ability to take risk compared to investors with jobs that are more sensitive to the performance of the economy.

Part Two: Willingness to Take Risk

Willingness to take risk measures your tolerance for risk. Specifically, we measure the amount of portfolio loss you are capable of experiencing without it significantly affecting your quality of life or causing you to change portfolio strategy. This is a crucially important aspect of risk since changing portfolio strategy after you experience risk is something your portfolio may not recover from.

Part Three: Need to Take Risk

Need to take risk is directly tied to your rate-of-return objective. If you need relatively high returns to achieve your goals, your need to take risk is high. But this will require a more aggressive asset allocation, which could be in conflict with your ability or willingness to take risk. Need to take risk is high for investors that expect to withdraw (or are withdrawing) a relatively high proportion of their investment portfolios to fund living expenses.

Part Four: Tracking Variance Risk

Some investors are sensitive to how their portfolio performs relative to well-known U.S. stock indexes like the S&P 500. While we encourage you not to constantly compare portfolio returns to benchmark returns since it can lead to counterproductive, returns-chasing behavior, we nevertheless cannot ignore the tendency for some investors to make this comparison. The two sources of tracking variance in the portfolios we customarily build for clients are allocations to international and emerging market stocks and tilts toward small-cap and value-oriented stocks. Investors who are highly sensitive to underperformance of indexes like the S&P 500 might want to consider less exposure to international stocks and less tilt toward small-cap and value stocks. We caution, though, that these portfolios will have less diversification and less expected return compared to the portfolios we would typically otherwise recommend.

Step Three: Understanding the Investment Strategy

We are big advocates of client education. More educated clients have a better understanding of why we make the investment strategy recommendations we do and most importantly are more likely to remain disciplined with their investment strategy approach, which increases the likelihood of achieving the goals they set out to accomplish. While client education can happen over time, there are basic elements of our approach that we want clients to understand from the outset.

We practice an evidence-based approach to investing. The focus of our firm's Investment Policy Committee (IPC) is understanding the investment best practices and body of knowledge defined by the last 50-plus years of academic and practitioner research. This research is ongoing and will continue to inform the recommendations we make to our clients. Importantly, our investment strategy guidance is not defined by what any member of the IPC "thinks" markets, the economy or interest rates are going to do. This approach to investing, typically referred to as "active management," has been shown to be counterproductive and a highly unreliable way to achieve financial goals. We believe there are six key tenets associated with evidence-based investing (EBI).

1. Outperforming the market is difficult. While we do believe there are ways to build portfolios with higher expected returns than the stock market through strategic allocation decisions informed by academic evidence, we never lose sight of the fact that outperforming the market is not easy. Given this fact, we recommend portfolios that are diversified, are tax efficient and follow the academic evidence while maintaining reasonable costs.

2. Global stock market diversification is the starting point. The academic evidence shows that investors should own U.S., international and emerging markets stocks, not concentrating solely on U.S. companies. This research shows that diversification across countries makes sense in the same way that diversification across companies does.

Over half of the world's stock market value is located in non-U.S. companies. We have no way of knowing which particular country will generate the highest long-term returns (and we do not believe anyone else does either), so diversification is the right strategy.

3. Size, value and momentum tilts can increase expected return. There is abundant academic evidence showing that small-cap stocks have generated higher long-term returns than large-cap stocks, that value stocks — which are stocks with low prices relative to earnings — have outperformed growth stocks and that positive momentum stocks — which are stocks with high returns over the last year — have outperformed negative momentum stocks. We try to capture these long-term return premiums through the stock and alternatives funds we use to give our clients the best possible chance of generating returns equal to or better than the overall market.

4. The primary role of fixed income is to reduce portfolio volatility. We believe that academic and practitioner evidence shows that the most efficient way to build portfolios is by taking risk through the stock and alternatives portion of the portfolio and using fixed income to reduce portfolio risk. Our fixed income recommendations primarily emphasize U.S. government-backed securities and high-quality municipal bonds since these securities tend to provide the most effective diversification of stock and alternative market risks.

5. Academic evidence supports modest use of alternative investment strategies. While we are generally skeptical of most alternative investment strategies, we believe there are a few alternative strategies accessed in mutual fund form that can enhance portfolio expected return and/or reduce portfolio volatility. Allocations here, however, should be relatively modest since some of these strategies have relatively high expense ratios, may be tax inefficient and the interval fund structure alternatives are not liquid.

6. EBI slowly evolves over time. Importantly, EBI is not static. Our investment strategy recommendations will evolve as academic and practitioner evidence evolves.

We cannot cover all aspects of our investment strategy in this white paper and will supplement with additional education over time but understanding these six concepts will go a long way toward helping you understand the portfolio recommendations that we make.

Once we better understand you as a client, have assessed various aspects of risk and spent time educating you about our evidence-based approach, this step concludes with developing your Investment Plan and Investment Policy Statement (IPS). There's a saying that those who fail to plan, plan to fail. It is very difficult to make rational decisions about investments without a plan. The Investment Plan and IPS show the target asset allocation for the portfolio we have identified as the one most suited for helping you achieve your goals. It also shows guidelines that indicate when the portfolio has drifted too far from its target and it is time to rebalance. These guidelines help provide the discipline necessary for a successful investment strategy.

Step Four: Building Your Portfolio

One question we commonly get asked is whether the portfolio should be implemented all at once or implemented over time through dollar-cost averaging (DCA). Research shows that DCA is generally counterproductive since markets tend to go up over time and delaying investment through DCA will therefore typically reduce the returns you earn. Yet another question we get asked is whether investments in certain portions of the portfolio (e.g., emerging markets stocks) should be delayed as a result of current events or past performance. We are big believers in the notion that short-term performance results are virtually unpredictable. The Asset Class Returns chart below makes this point.

Asset Class Returns[1]

2006–2020

2006	2007	2008	2009	2010	2011	2012	2013
Real Estate 36.0%	Emerging Markets 39.8%	U.S. IG Bonds 10.4%	Emerging Markets 82.4%	Real Estate 28.1%	Real Estate 9.4%	Int’l Small Value 19.5%	U.S. Small Value 34.5%
Emerging Markets 31.7%	Int’l Large Neutral 12.4%	Global Short Bonds 6.6%	Int’l Small Value 52.6%	U.S. Small Value 24.5%	U.S. IG Bonds 6.1%	Emerging Markets 18.7%	U.S. Large Value 32.5%
Int’l Large Value 29.3%	U.S. IG Bonds 8.5%	Cash 2.1%	Int’l Large Value 36.7%	Int’l Small Value 20.7%	Global Short Bonds 2.3%	U.S. Small Value 18.1%	S&P 500 32.4%
Int’l Small Value 27.4%	Int’l Large Value 6.9%	U.S. Small Value -28.9%	Int’l Large Neutral 33.7%	Emerging Markets 19.9%	S&P 500 2.1%	U.S. Large Value 17.5%	Int’l Small Value 27.7%
Int’l Large Neutral 25.7%	Global Short Bonds 6.3%	U.S. Large Value -36.8%	Real Estate 28.5%	U.S. Large Value 15.5%	U.S. Large Value 0.4%	Int’l Large Value 17.3%	Int’l Large Value 21.5%
U.S. Small Value 23.5%	S&P 500 5.5%	S&P 500 -37.0%	S&P 500 26.5%	S&P 500 15.1%	Cash 0.1%	Real Estate 17.1%	Int’l Large Neutral 21.0%
U.S. Large Value 22.2%	Cash 5.0%	Real Estate -39.2%	U.S. Small Value 20.6%	Int’l Large Neutral 8.9%	U.S. Small Value -5.5%	Int’l Large Neutral 16.4%	Real Estate 1.2%
S&P 500 15.8%	Int’l Small Value 2.0%	Int’l Large Neutral -43.6%	U.S. Large Value 19.7%	U.S. IG Bonds 5.0%	Int’l Large Value -11.7%	S&P 500 16.0%	Global Short Bonds 0.6%
Cash 4.9%	U.S. Large Value -0.2%	Int’l Large Value -44.3%	Global Short Bonds 2.3%	Int’l Large Value 4.8%	Int’l Large Neutral -12.2%	Global Short Bonds 2.1%	Cash 0.1%
Global Short Bonds 4.1%	U.S. Small Value -9.8%	Int’l Small Value -45.9%	Cash 0.2%	Global Short Bonds 2.0%	Int’l Small Value -16.8%	U.S. IG Bonds 1.7%	U.S. IG Bonds -1.2%
U.S. IG Bonds 3.8%	Real Estate -17.6%	Emerging Markets -53.8%	U.S. IG Bonds -0.3%	Cash 0.1%	Emerging Markets -19.5%	Cash 0.1%	Emerging Markets -2.2%

2014	2015	2016	2017	2018	2019	2020
Real Estate 32.0%	Real Estate 4.5%	U.S. Small Value 31.7%	Emerging Markets 36.8%	Global Short Bonds 2.1%	S&P 500 31.5%	S&P 500 18.4%
S&P 500 13.7%	S&P 500 1.4%	U.S. Large Value 17.3%	Int’l Small Value 27.9%	Cash 1.9%	U.S. Large Value 26.5%	Emerging Markets 18.4%
U.S. Large Value 13.5%	U.S. IG Bonds 1.2%	S&P 500 12.0%	Int’l Large Neutral 24.2%	U.S. IG Bonds 1.4%	Real Estate 23.1%	Int’l Large Neutral 7.6%
U.S. Small Value 4.2%	Int’l Small Value 1.1%	Emerging Markets 9.9%	S&P 500 21.8%	Real Estate -4.2%	Int’l Small Value 22.8%	U.S. IG Bonds 5.7%
U.S. IG Bonds 2.5%	Global Short Bonds 1.0%	Int’l Small Value 7.9%	Int’l Large Value 21.0%	S&P 500 -4.4%	Int’l Large Neutral 22.5%	U.S. Small Value 4.6%
Global Short Bonds 1.9%	Cash 0.1%	Int’l Large Value 7.4%	U.S. Large Value 13.7%	U.S. Large Value -8.3%	U.S. Small Value 22.4%	Global Short Bonds 3.2%
Cash 0.0%	Int’l Large Neutral -3.0%	Real Estate 6.7%	U.S. Small Value 7.8%	U.S. Small Value -12.9%	Emerging Markets 17.7%	U.S. Large Value 2.8%
Emerging Markets -1.8%	U.S. Large Value -3.8%	Int’l Large Neutral 2.7%	Real Estate 3.8%	Int’l Large Neutral -14.1%	Int’l Large Value 17.0%	Int’l Small Value 2.6%
Int’l Large Neutral -4.3%	U.S. Small Value -7.5%	Global Short Bonds 1.5%	U.S. IG Bonds 1.1%	Emerging Markets -15.0%	U.S. IG Bonds 5.2%	Cash 0.7%
Int’l Large Value -5.4%	Int’l Large Value -7.7%	U.S. IG Bonds 1.1%	Global Short Bonds 1.1%	Int’l Large Value -15.1%	Global Short Bonds 3.9%	Int’l Large Value -3.2%
Int’l Small Value -5.9%	Emerging Markets -13.9%	Cash 0.3%	Cash 0.9%	Int’l Small Value -18.4%	Cash 2.3%	Real Estate -11.2%

	15 Year Annualized Returns	Best Year	Worst Year
S&P 500	9.9%	32.4%	-37.0%
U.S. Large Value Stocks	7.3%	32.5%	-36.8%
U.S. Small Value Stocks	6.9%	34.5%	-28.9%
Emerging Markets Total Stock Market	6.6%	82.4%	-53.8%
Real Estate	5.8%	36.0%	-39.2%
International Small Value Stocks	5.5%	52.6%	-45.9%
International Large Neutral Stocks	4.5%	33.7%	-43.6%
U.S. Intermediate Government Bonds	3.4%	10.4%	-1.2%
International Large Value Stocks	2.8%	36.7%	-44.3%
Global Short Bonds	2.7%	6.6%	0.6%
Cash & Cash Alternatives	1.2%	5.0%	0.0%

[1] Source: Morningstar Direct 2021. Index representation as follows: S&P 500 (S&P 500), U.S. Large Value Stocks (Russell 1000 Value), U.S. Small Value Stocks (Russell 2000 Value), Emerging Markets Total Stock Market (MSCI Emerging Markets IMI NR), Real Estate (DJ US Select REIT), International Small Value Stocks (MSCI World Ex USA Small Value NR), International Large Neutral Stocks (MSCI World ex USA NR), U.S. Intermediate Government Bonds (Bloomberg Barclays US Government Intermediate Index), International Large Value Stocks (MSCI World Ex USA Value NR), Global Short Bonds (FTSE WGBI 1-5 Yr Hdg USD), Cash & Cash Alternatives (ICE BofAML US 3M Trsy Bill). Indexes are unmanaged baskets of securities that are not available for direct investment by investors. Index performance does not reflect the expenses associated with the management of an actual portfolio. This information should not be considered as a demonstration of actual performance results or actual trading using client assets and should not be interpreted as such. All investments involve risk, including loss of principal. Foreign securities involve additional risks, including foreign currency changes, political risks, foreign taxes, and different methods of accounting and financial reporting. Fixed income investments are subject to interest rate and credit risk. Emerging markets involve additional risks, including, but not limited to, currency fluctuation, political instability, foreign taxes, and different methods of accounting and financial reporting. Real estate securities funds are subject to changes in economic conditions, credit risk and interest rate fluctuations. Charts are for illustrative purposes only and these are not representative of any client account. Time period of fifteen years was chosen to reflect a representative historical illustration of longer term effects of diversification.

This chart shows the year-by-year returns of various asset classes like U.S. large-cap stocks (S&P 500 Index), U.S. small-cap value stocks and real estate investment trusts (REITs). As you can see, it is hard to see any pattern in the year-by-year results. Performance is difficult to predict and we think that, once we have identified an overall portfolio that helps achieve your goals, implementing all the asset classes in that portfolio is the right approach. Beyond these two points, here are five other things to understand about our general approach to building your portfolio.

1. We use low-cost, evidence-based funds to implement the stock allocation. We are big believers that costs matter and that investors should avoid using actively managed funds where an individual person or management team is attempting to outperform the market. Instead, we use low-cost funds that try to capture the dimensions of return identified by decades' worth of academic research. These funds are rules based and not reliant on an individual person or management team's beliefs about the overall market or individual stocks.

2. We use either low-cost bond funds or individual bonds to implement the fixed income allocation. Whether you are best served by owning a fixed income mutual fund (or funds) or a customized individual bond portfolio, we believe the proper role of fixed income within a portfolio is to reduce overall portfolio risk or to provide an ongoing, stable income source (or some combination of both). To accomplish this vital role, our approach to fixed income investing is entirely evidence-based regardless of the vehicles used. We do not believe in selecting mispriced securities, timing the market, guessing either the direction of interest rates or future shape of the yield curve, or making similar attempts to beat the market.

3. We may use alternative strategies for a modest portion of the overall allocation. As previously mentioned, academic research has uncovered the benefits that some alternative strategies can add by either enhancing portfolio diversification or improving expected return. The alternative investment strategies we use are held in mutual fund form. We also do recommend modest allocations since these strategies have higher expenses, are typically less tax efficient and the interval fund alternatives are not liquid.

4. We use strategic asset location to improve after-tax returns. We will look to place less tax-efficient asset classes like alternatives and fixed income in tax-advantaged accounts. Over time, this should help reduce your tax burden and consequently improve after-tax return. It also means that each account will not be allocated the same since some asset classes may be held in one account but not in others. Focusing on achieving the overall allocation in a tax-efficient manner is the reason for this approach.

5. We look for other ways to improve the tax efficiency of your portfolio by using tax-managed funds and municipal bonds when appropriate. Tax-managed funds are mutual funds that explicitly look to harvest capital losses and defer gains to improve tax efficiency.

The end result of our overall process is a low-cost, tax-efficient and globally diversified portfolio suited to help you achieve your goals while being cognizant of risk.

Step Five: Ongoing Maintenance

Ongoing maintenance takes many forms. One of the more important aspects is portfolio rebalancing. We set target allocations for each asset class held in your portfolio and periodically review the portfolio to make sure the actual allocation to each asset class has not drifted too far from the target. If it has, we will then sell asset classes that are over their target weights by a significant amount and purchase asset classes that are under their target weights.

Importantly, we set “tolerance bands” around the target allocation for each asset class to ensure the weight must move by a significant amount before rebalancing is needed. This helps reduce trading costs and, potentially, taxes, while ensuring that rebalancing will occur when weights deviate significantly from the target weights.

Ongoing maintenance also includes tax-efficient management of the portfolio. We will proactively look to harvest capital losses when investments decline in taxable accounts so that these capital losses can be used to offset future capital gains. Your federal and state tax rates may also change over time, which can influence the investment strategies that we use in taxable accounts. In particular, municipal bonds may be the best fixed income option at relatively high federal income tax rates but may not make sense at lower federal income tax rates. For clients in the withdrawal phase, we also help with a tax-efficient approach to spending out of the portfolio since withdrawals from various account types can have significantly different tax implications.

Discovery continues for the length of our relationship with a client. As life progresses, your financial goals, health and values will likely change. These changes can have implications for what asset allocation strategy makes the most sense, the size of withdrawals needed from your portfolio and other aspects of your financial well-being. As we meet with our clients, we strive to stay on top of these changes and help you understand the impact of these changes from a financial perspective.

We conclude with why our firm has adopted an evidence-based investing approach. We believe our approach fosters a relationship grounded in fiduciary obligation, while effectively incorporating academic evidence on how markets can be used to pursue your financial independence. Just as asset allocation should be among the first steps toward building a long-term portfolio to meet your unique goals, selecting an advisor who espouses an evidence-based approach can be among the first steps toward building a long-term trusted advisor relationship.

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