Investing 101

Matt Sturdivan, CFA

Director, Traditional Markets Research

RVK, Inc.

Portland, Oregon

International Foundation OF EMPLOYEE BENEFIT PLANS

Session Mission and Outline

- Institutional investors impact the future of their communities and lives of their beneficiaries. This session aims to provide key information to help fulfill this mission.
  - Overview of markets
  - Benefits of diversification
  - Key drivers of market movements
  - Improving portfolio durability
  - Tips on implementation

Key Terms

- Asset Class: Grouping of similar investments (e.g., stocks, bonds or real estate)
- Correlation: Statistic showing whether two investments move in the same (positive) or oppositive (negative) direction at the same time.
- Diversification: Investing in multiple asset classes with low correlations to reduce the choppiness of returns.
- Liquidity: Measure of how quickly an asset can easily be bought or sold.
- Manager: Firm that offers an investment strategy (e.g., mutual fund).
- Rebalance: Selling asset classes with strong performance and buying asset classes with weaker performance to remain within stated long-term targets.
- Volatility: Statistic showing how significantly prices move up and down within an asset class or strategy.

But First, a Little Exercise

Market Scenario 1

- A rational investor may review this situation and determine that pushing more money toward stocks is supported by the current conditions.

Economic Growth	Inflation	Recent Stock Market Returns	Recent Bond Market Returns
Generally considered healthy, with marginal decline expected from recent peaks.	Stable upward trend, within range of historical averages.	S&P 500 Index averaged an 8% return over the past three years.	Broad bonds averaged a 4% return over the past three years.

Market Scenario 1

- This scenario represents the year-end conditions of 2007. With the onset of the Great Financial Crisis riskier asset classes sold off significantly.

THE WALL STREET JOURNAL.

Mounting Fears Shake World Markets As Banking Giants Rush to Raise Capital

Morgan Stanley in Talks With Wachovia, Others

Reaching Down

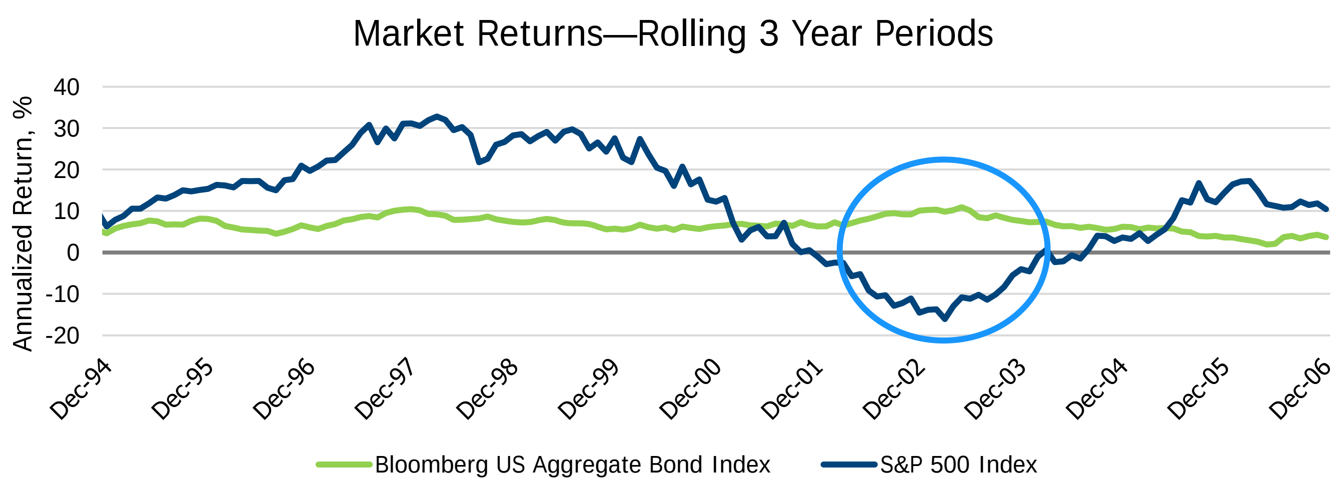
Market Scenario 2

- A rational investor may review this situation and determine that stocks are not worth the additional volatility relative to bonds.

Economic Growth	Inflation	Recent Stock Market Returns	Recent Bond Market Returns
Viewed as a slow recovery from a recent recession.	Low, viewed as resulting from a tepid economic recovery.	S&P 500 Index averaged a -14% return over the past three years.	Broad bonds averaged a 10% return over the past three years.

Market Scenario 2

- This scenario represents the year-end conditions of 2002. Equity markets rebounded over the next few years following the “Dot-com bubble” crash.



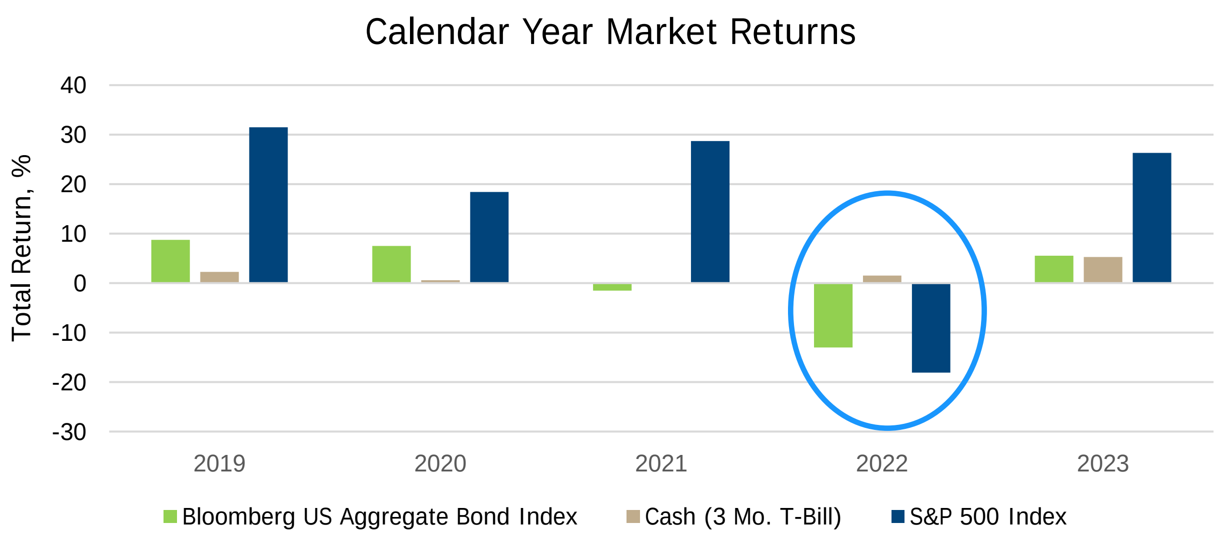
Market Scenario 3

- A rational investor may review this situation and decide to park more assets in safety (e.g., savings account) given the market uncertainty.

Economic Growth	Inflation	Recent Stock Market Returns	Recent Bond Market Returns
Increasing calls for recessions in the year ahead.	Historically high levels with decreasing confidence that it can be contained.	S&P 500 Index declined by more than 18% in the year prior.	Broad bonds declined by more than 13% in the year prior.

Market Scenario 3

- This scenario represents the year-end conditions of 2022. Stocks and bonds subsequently rebounded the following year.



Market Scenario Recap

- Market shocks are not predictable.
- Timing markets over short-term periods is difficult.
- There are different return and risk levels of asset classes (stocks, bonds, etc.) over the long-term.
- Long-term investors can structure portfolios with strategic weights and take advantage of rebalancing opportunities.

Overview of Markets

The Tools

- Different Investment Types
  - Publicly Traded Stocks
  - Publicly Traded Bonds
  - Private Markets (Equity, Debt and Real Estate)
  - Alternatives (Hedge Funds, Commodities, etc.)
- Each of these investments are available at different risk levels and complexity

The Toolbox

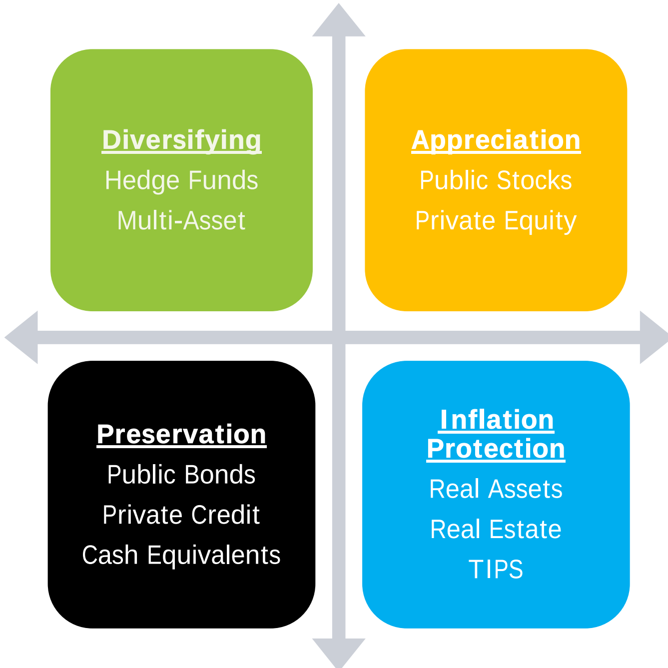
- **Risk and return assumptions** can be used to determine reasonable allocation ranges for each to meet a specific return target.
- Stocks and Bond can be invested **actively or passively**.
- Private Markets and Alternative investments are typically active by nature.
- Cash/Cash Equivalents

Standard Asset Class Definitions

- The “why” behind stocks and bonds.
  - Stocks allow companies to raise capital through offering shares of ownership.
    - Investors purchase shares of company ownership to potentially benefit from company growth, dividend payments and price appreciation.
  - Companies, governments, and other entities issue debt in order to finance operations and projects.
    - Investors purchase bonds to receive regular and fixed-rate or floating-rate payments followed by repayment of capital.

Asset Class Thematic Groupings

- Asset classes can serve specific roles within a portfolio.



Asset Classes: Further Details

	Cash and Inflation	Fixed Income	Domestic Equity	International and Global Equity	Real Estate	Alternative Strategies
Investments/ Strategies	Money Market, Funds, T-bills, Commercial Paper	Government or Corporate Credit, Asset-backed Securities	US Stock	Developed International Equity and/or Emerging Markets	REITs, Commingled Funds, Direct Investments	Private Equity, Diversified Hedge Funds, GTAA, Real Return Strategies
Risk/Return Profile	Low	Moderate	High	High	Moderate to High	Moderate to High
Role in Portfolio	Stability and liquidity	• Stability as well as capital appreciation preservation to portfolio • Hedge against economic slowdown or inflation	• Long Term Growth Potential • Income through dividends (in some cases)	• Long Term Growth Potential • Diversification from US market exposure	• Inflation protection and income potential • Diversification from stocks and bonds	• Various, depending on strategies • Diversification from traditional asset classes
Other Attributes		Value/price fluctuates inversely with interest rate movement			Liquidity concerns and severe market downturns can pose increased risk to the portfolio	Less liquid, less transparent (harder valuations) and often higher associated fees

Benefits of Diversification

Diversification

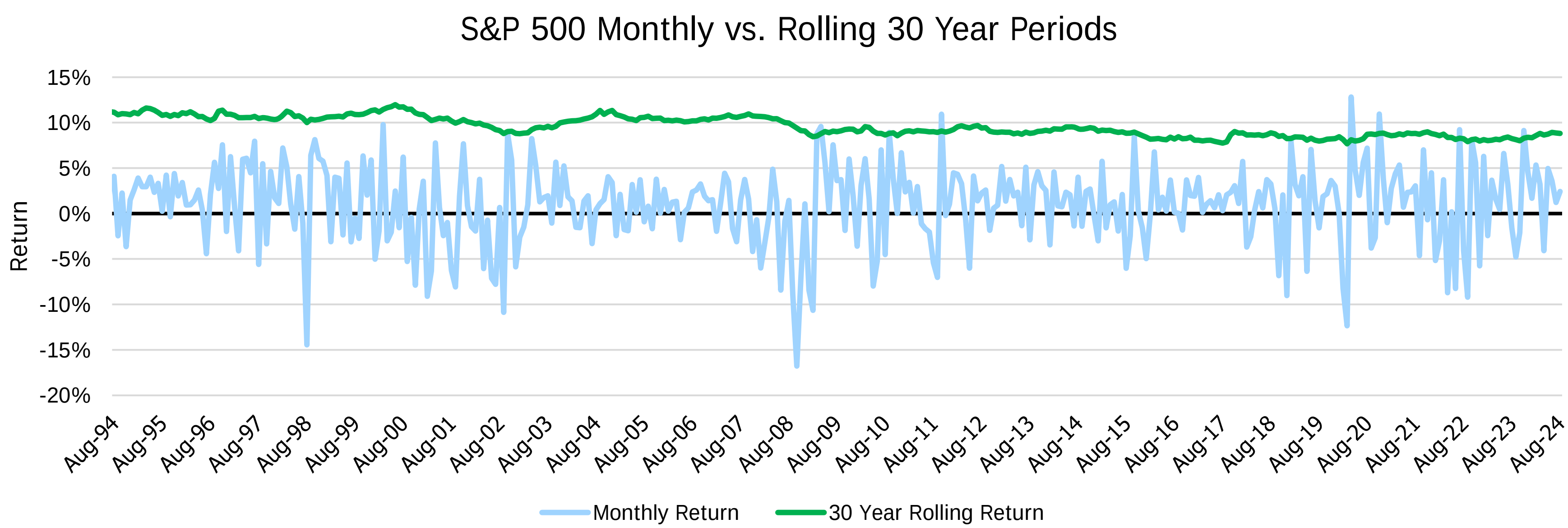
- Diversification requires investing in asset classes that behave differently as market conditions change.
- Investors seeking a steady return pattern can benefit from diversifying into multiple asset classes.
- Asset classes are “diversifying” to the extent they can provide different return patterns (e.g., bonds can rise when stocks fall).

Why Diversify?

- It may be intuitive to simply select the asset with the highest potential long-term return, however single asset classes can have high volatility. Important considerations below:
  - The high long-term return may not happen.
  - Funds may be needed at troughs in market value.
  - Risk preferences may change over time which require the ability to rebalance into other asset classes.

Short-Term Returns Are Variable

- Selecting a high return asset class can come with increased short-term volatility.



Evolution of Diversification

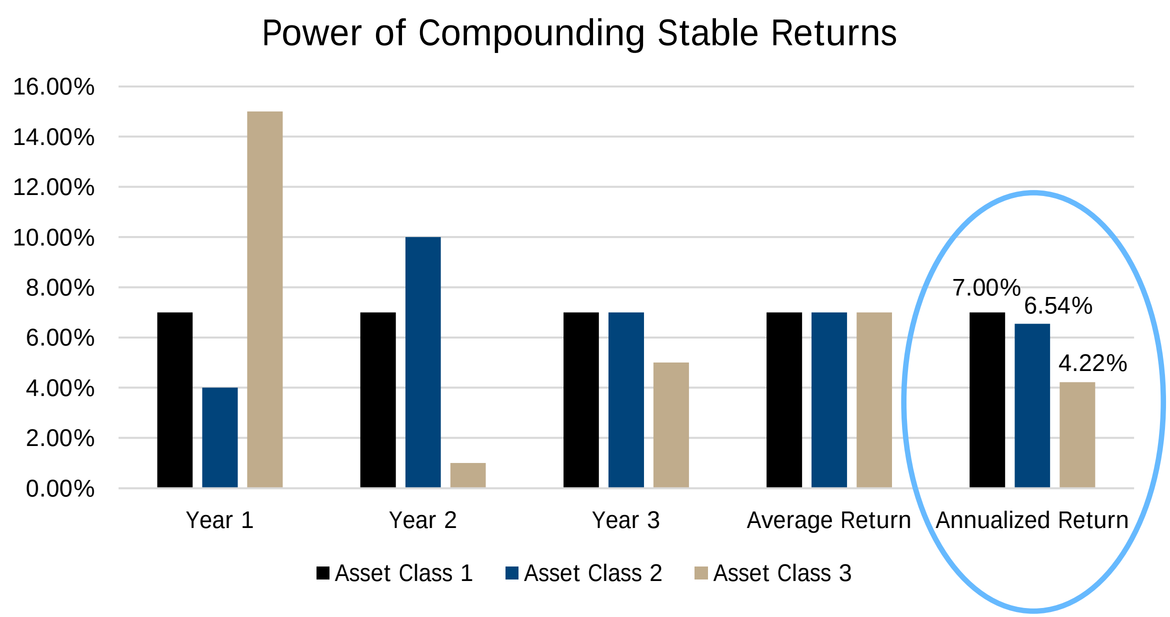
- A standard portfolio approach has been to combine a 60% allocation to stocks with a 40% allocation to bonds.
  - The pairing is rational, stocks provide higher returns potential while bonds can provide downside protection.
- However, the choppiness of portfolio returns can be further reduced by adding other asset classes.

The Menu of Options

- A portfolio mix can include asset classes with different expected returns and risk to reduce its reliance on the success of a single asset class.

Return Path Matters

- Investors can lean into the power of compounding returns to benefit over the long-term.



Wisdom Break

"An investment in knowledge
pays the best interest."

—Benjamin Franklin

Key Drivers of Market Movements

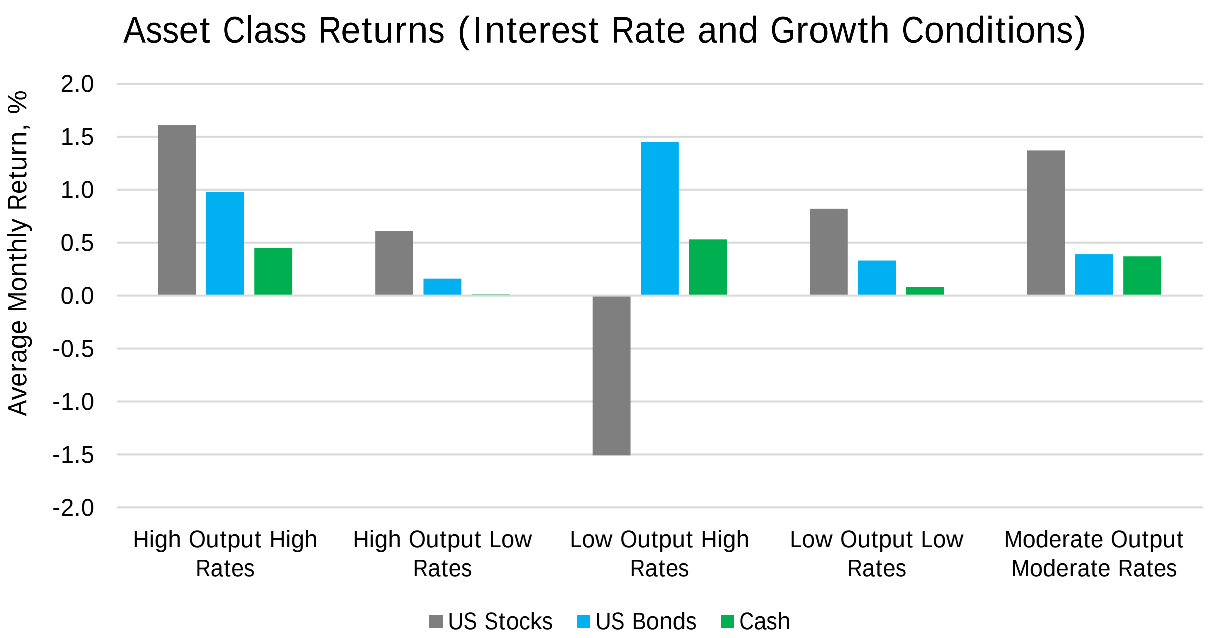
Interest Rates Overview

Definitions

- ***Interest rates*** represent the yield (or income) offered by a bond.
- ***Interest rate sensitivity*** tells us how the price of a stock or bond (or portfolio of stocks and/or bonds) will likely change as reference rates (such as the Federal Funds Rate) change.
  - **Reminder**: Bond prices increase (decrease) as rates decline (rise).
  - Another word for interest rate sensitivity is ***duration***—*Generally, the higher the duration, the more sensitive a bond is to a change in rates.*
  - The future value of money is inversely related to interest rates, lower rates increase the future value of money. Asset prices fluctuate as the future value of money changes.

Impact of Interest Rates

- Economic conditions can significantly impact asset class returns.



Stocks—Tracking Fundamentals

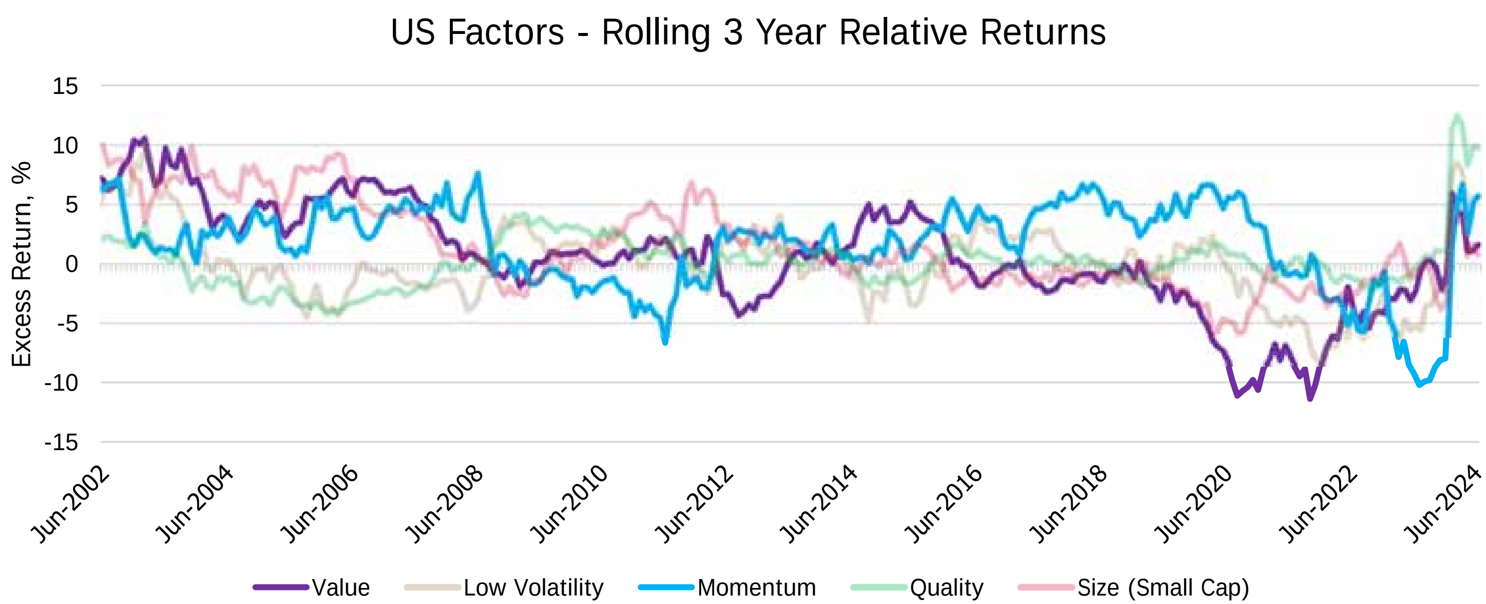
- Long-term stock returns are driven by the "fundamentals" of the underlying companies.
  - Fundamentals is a catch-all term which generally includes dividend yield, valuation and growth.
  - Dividend yield: Dividend payout relative to price.
  - Valuation: Price level relative to earnings (P/E ratio) or other price-relative ratios.
  - Growth: The earnings or sales growth the company is expected to generate over the next 5 years.

Stocks—Other Drivers

- Multiple “factors” have been shown to impact stock returns.
  - **Value—Stocks trading at discounts to their historical or long-term value.**
    - Securities are scored using Price-to-Book, Price-to-Forward Earnings, and Enterprise Value-to-Cash flow.
  - **Quality—Stocks with stable profitability compared to peers.**
    - Securities are scored based on their Return-on-Equity, leverage ratio, and earnings stability.
  - **Low Volatility—Stocks that have exhibited lower volatility relative to peers.**
  - **Size (Small Cap)—Stocks of smaller companies.**
    - These stocks have higher risk and potentially higher return.
  - **Momentum—Stocks that have outperformed over the last 12 months (or other similar short-term periods).**

Stocks—Expect Volatility

- Stock return factors are favored by the market at different points in a cycle.



Bonds—Rate, Credit and Liquidity Drivers

- **Interest Rate Risk:** *How sensitive is the portfolio to interest rate movements?*
  - The price of existing bonds and interest rates are inversely related.
  - Duration measures sensitivity to interest rates, stated in years.
  - All else equal, longer maturity bonds and lower coupon bonds will be more sensitive to interest rates.
- **Credit Risk:** *How likely am I to be paid back?*
  - Credit risk is assessed based on the borrowers' ability to repay.
  - Credit rating agencies evaluate and publish ratings for thousands of corporate and government bond issuers.
- **Liquidity Risk:** *Can I sell quickly, at a reasonable price?*
  - Unlike stocks, many bonds do not trade daily.
  - U.S. government debt (e.g. Treasuries and agencies) is considered a highly liquid bond sector, whereas high yield, bank loans, and emerging market bonds are generally less liquid— Sometimes considerably so.

S&P Ratings	
AAA	Investment grade
AA	
A	
BBB	
BB	Non-investment grade
B	
CCC	
CC	
C	
D	

Improving
Portfolio Durability

Limit Overreaction to Noise

- Behavioral biases can cause investors to act on emotion rather than long-term strategy.
  - Studies show that investors can overreact to bad news and underreact to good news.
  - These short-term reactions can lead to poorly timed allocation decisions.
  - Changes to asset class allocations should be due to shifts in long-term risk/return fundamentals or a change in return needs.

Avoid Unintended Risks

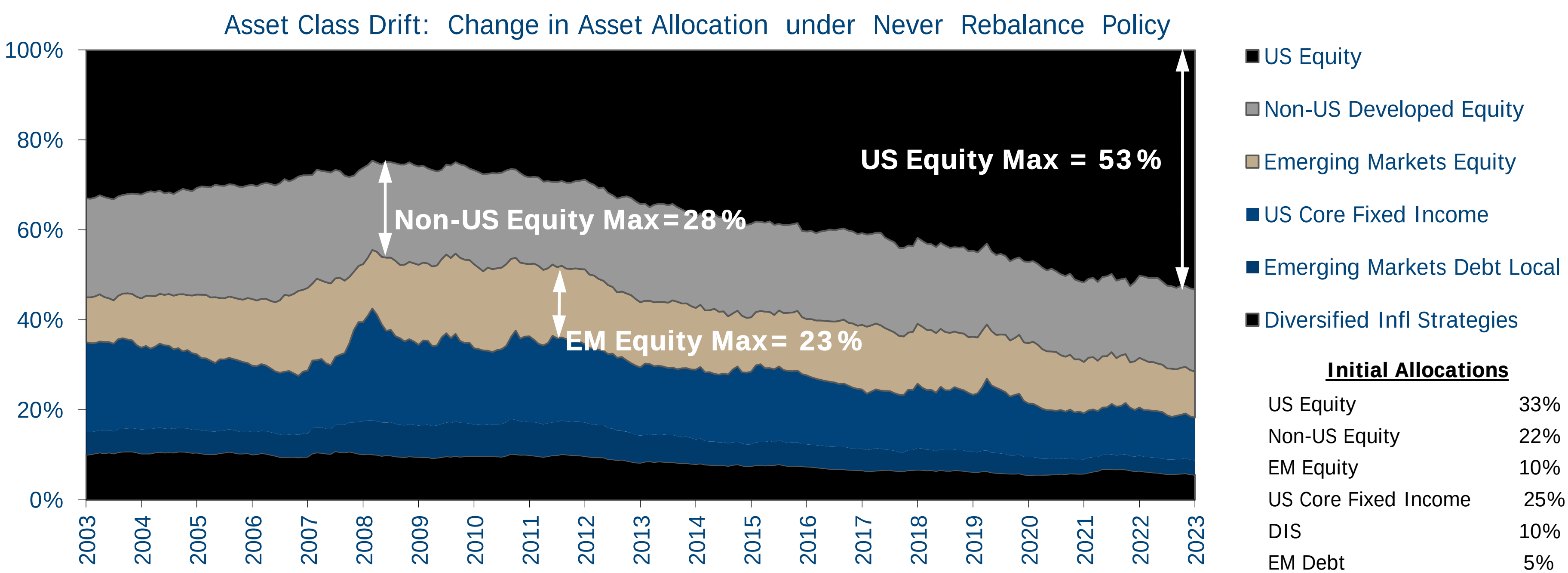
- Portfolio performance can be impacted by many different risks.
- Understanding the roles of each strategy in the portfolio can help gauge if an unintended risk exists in the portfolio.
- Key risks to monitor include major volatility contributors, known style biases, inflation or rate sensitivity and intended restrictions.

Disciplined Rebalancing

- Rebalancing is a crucial, but counterintuitive task as an investor is normally selling an asset with strong returns and investing in one with weaker returns.
  - – Helps smooth returns and downside risk allowing for a more stable portfolio value to consistently meet obligations.
  - – For example, aiming for a 55-65% allocation to stocks requires rebalancing when the allocation reaches the upper and lower limits.

Rebalancing Rationale

- More volatile asset classes can take over without rebalancing.



Initial Allocations

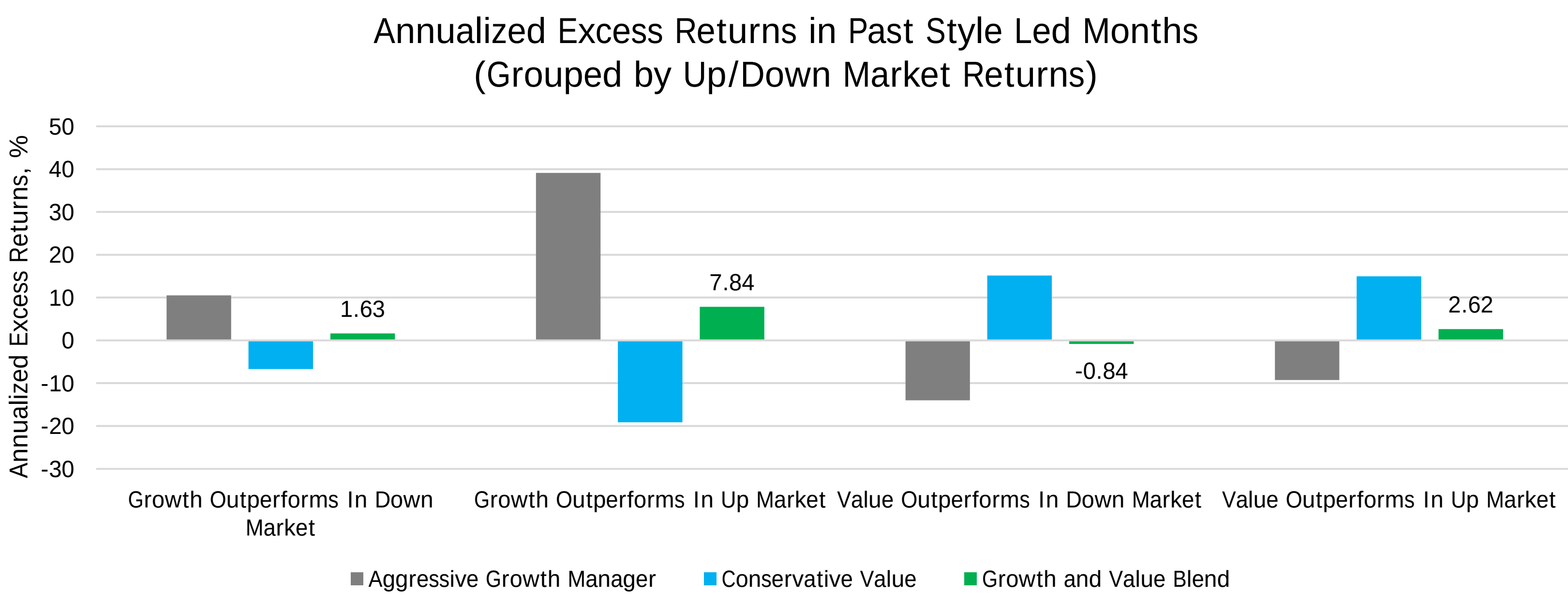
US Equity	33%
Non-US Equity	22%
EM Equity	10%
US Core Fixed Income	25%
DIS	10%
EM Debt	5%

Pairing Strategies

- Investors can seek further diversification by pairing managers within the same asset class (e.g., a growth stock and value stock manager).
- Style, risk and concentration are key elements of making a successful pairing.
- For example, a highly concentrated (low number of stocks), high-risk growth manager may be best paired with a diversified, low-risk value manager.

Understand Manager Return Patterns

- Appropriate manager pairings can help a portfolio navigate multiple environments.



Wisdom Break

"Risk comes from not knowing what you're doing."

—Warren Buffett

Tips on Implementation

Be Mindful of Fees

- Pay close attention to the fees being paid for your strategies and make sure to compare them to similar funds.
- Always ask or check whether there is a better “share class” for your investment size.
- Even top-tier investment managers can have difficulty adding value over high fees.

Improving Manager Selection

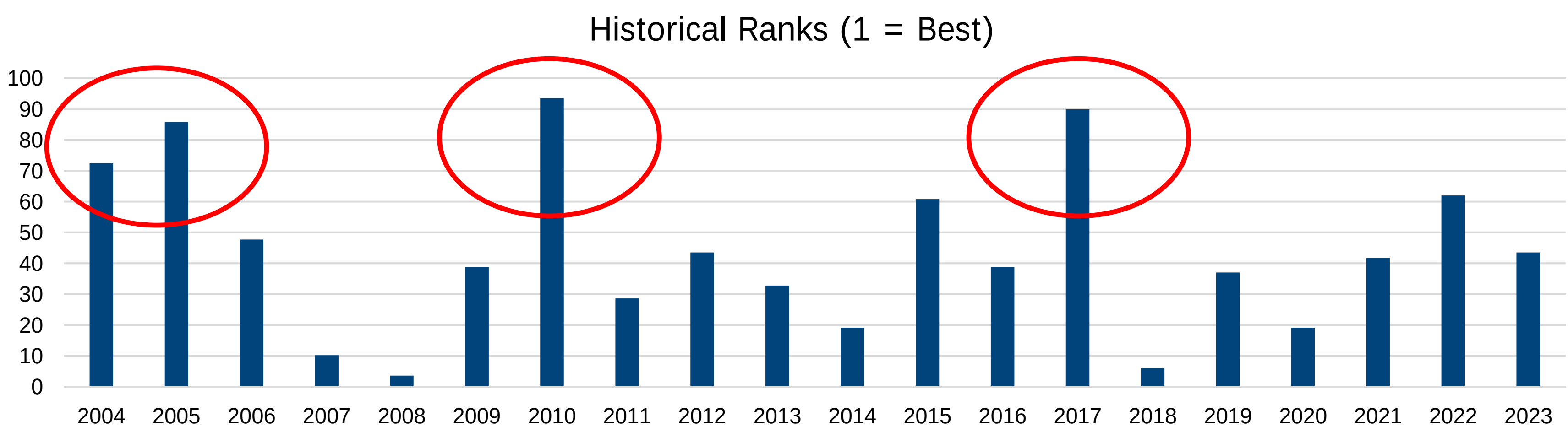
- Key Initial Questions
  - Are there major firm or team changes in the recent past which could shift the resources given to the strategy?
  - Has this manager outperformed in multiple years or are their returns driven by a single year/period?
  - Has the same portfolio manager been responsible for the track record being reviewed?
  - Is the cost competitive with peers?

Reduce Your Chances of Top-Ticking

- Recency bias can be difficult to overcome.
  - Top-ticking or “chasing the hot dot” is a frequent behavioral bias of investors to simply select the strategy or asset class which has done the best recently.
    - Performance often reverts to long-term averages.
    - The top performer for the past three years is not likely the top performer for the next three years.
    - Attempt to purchase strategies with strong long-term returns, but explainable recent performance struggles.

Path of a Top Ranked Manager

- The below historical ranks are for a top ranked U.S. large cap equity manager.
  - Even top-tier managers deliver disappointing years.
  - Investors can time buy/sell decisions based on recent data.



Vehicle Comparison

- Investors have multiple avenues for implementing an investment

Separate Accounts	Mutual Funds	Exchanged Traded Funds (ETFS)	Collective Trusts	Commingled Funds
More customizable, not necessarily lowest fee	Transparent, publicly available, fees vary	Exchange Traded Funds—Highly transparent, competitive fees	Similar to a mutual fund, normally at a lower fee, available to retirement plans	More common for private market investments, higher account minimums

Parting Thoughts

Parting Thoughts

- Build a portfolio you understand, know its limits, choose your partners carefully and <u>rebalance</u>.

Your Feedback Is Important.
Please Scan This QR Code.

Session Evaluation