

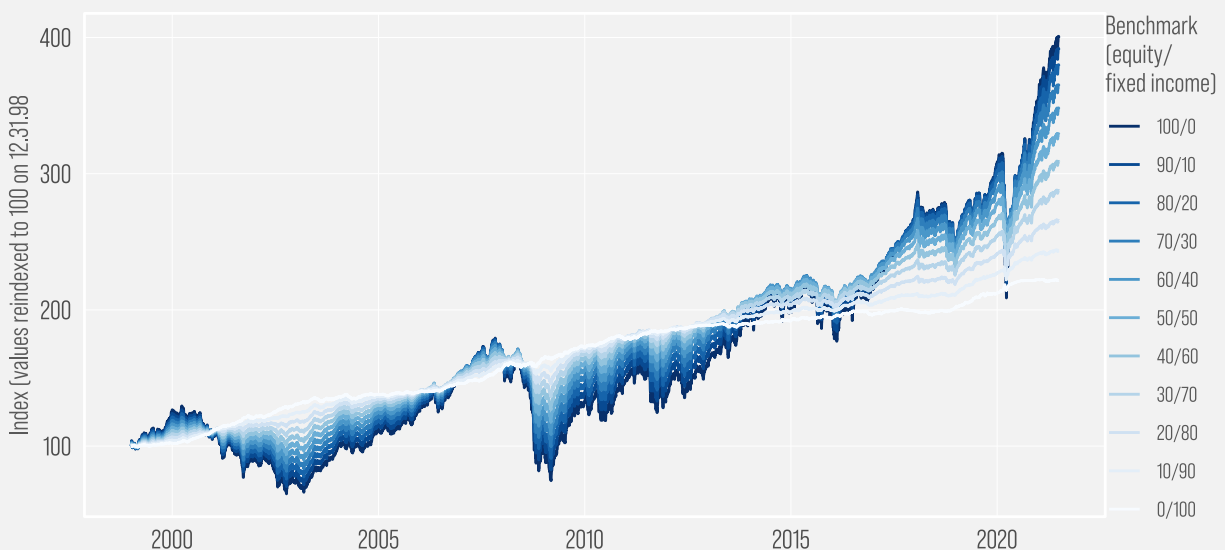
RISK IS. RETURN MIGHT

In our advisory work, we find two perspectives provide the basis for determining a level of exposure to investment risk appropriate for each client: capacity to take on investment risk and willingness to take on that risk. While capacity can be seen as more quantitative in its basis, an assessment of risk tolerance generally is more qualitative. Results from those two perspectives often don't match, which is why we continue to find regular discussions with regard to investment risk well supportive of progress toward financial goals.

A Thousand Words on Risk and Return

While return seems a more obvious concept to most folks, risk tends to present greater challenges to comprehension. We think that's because risk can be experienced in various ways: period-to-period changes in value (volatility) and/or longer-term drops in value (drawdown). While volatility metrics capture market ups and downs, drawdowns reflect persistent losses, which tend to be of more concern to clients. So when we host discussions with regard to investment risk, we often offer a view of market history such as that in Figure 1. In that chart we show all the benchmarks we use for our various investment portfolios, with each differentiated by its relative exposure to stocks and bonds. Because stocks tend to be riskier than bonds, stronger exposures to stocks historically have experienced larger drawdowns (see Figure 2). On the flipside, despite those drawdowns, longer-term returns have been stronger for increasing levels of stock exposure.

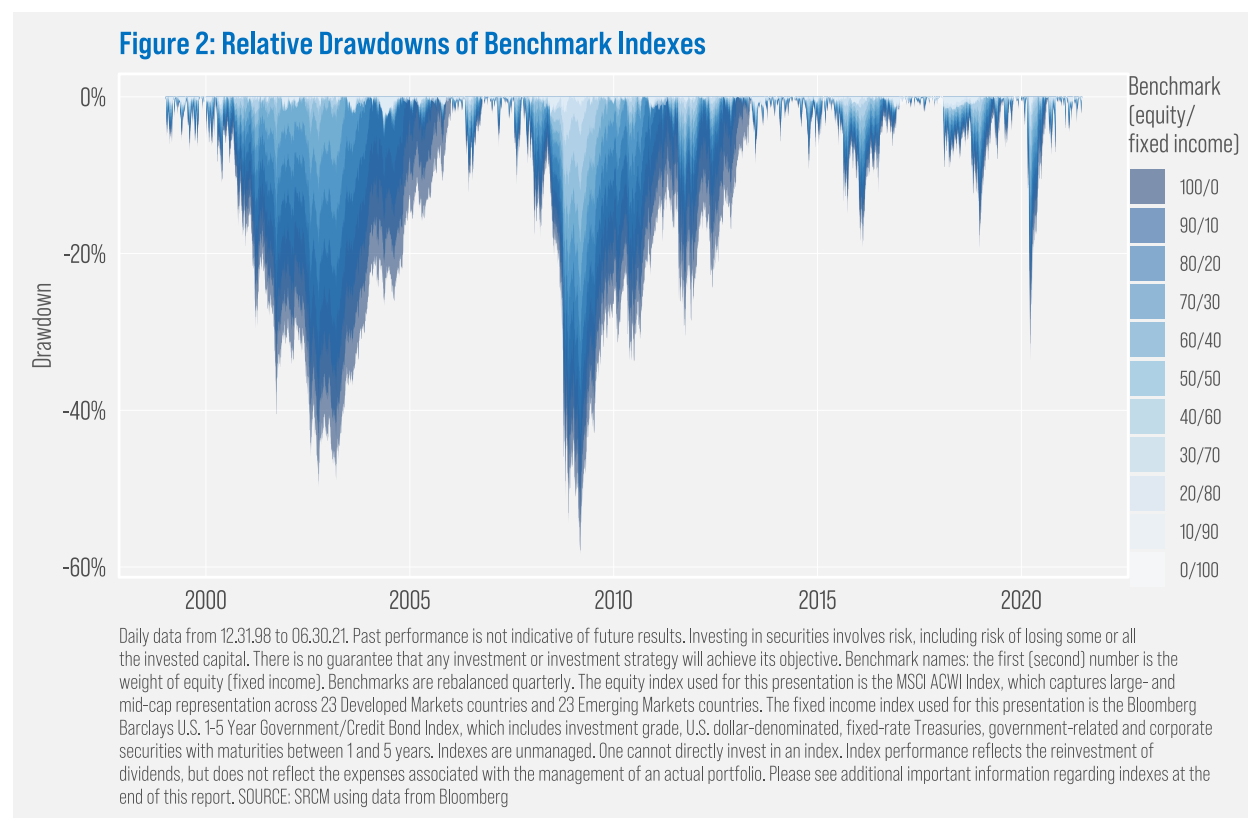
Figure 1: Long-Term Total Return of Benchmark Indexes



Daily data from 12.31.98 to 06.30.21. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Benchmark names: the first (second) number is the weight of equity (fixed income). Benchmarks are rebalanced quarterly. The equity index used for this presentation is the MSCI ACWI Index, which captures large- and mid-cap representation across 23 Developed Markets countries and 23 Emerging Markets countries. The fixed income index used for this presentation is the Bloomberg Barclays U.S. 1-5 Year Government/Credit Bond Index, which includes investment grade, U.S. dollar-denominated, fixed-rate Treasuries, government-related and corporate securities with maturities between 1 and 5 years. Indexes are unmanaged. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg

Evaluating Optimal Risk Exposure

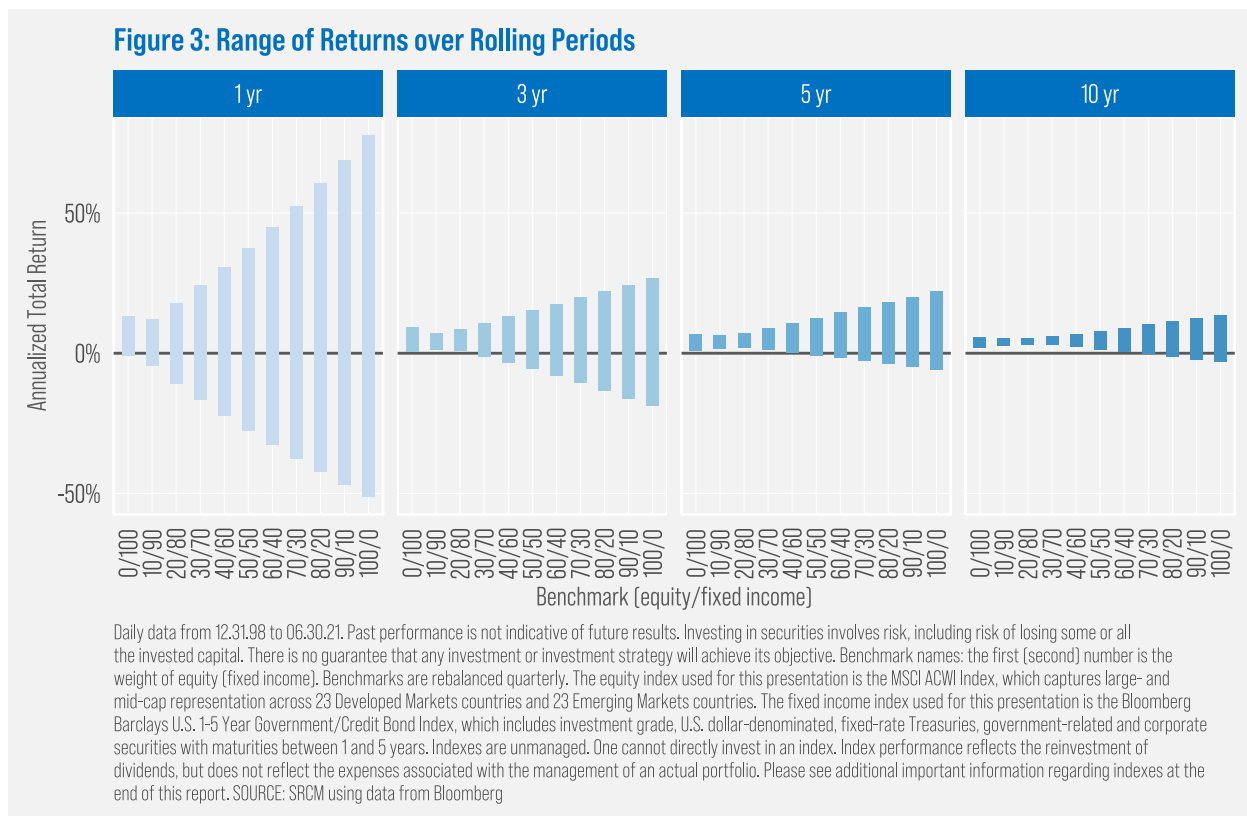
With potential drawdowns top of mind during the discussion, we can return to the two perspectives from which to view the risk drawdowns present: capacity and willingness. For capacity, we generally are seeking to define—where possible or otherwise to estimate—the investment time horizon of the monies to be invested. The time horizon can be measured in terms of dollar amounts that might be needed over particular time frames and the likelihood for those particular needs to be realized. This determination can be made for the portfolio as a whole or portions thereof. For example, one might know that a specific payment of a specific dollar amount might be needed on a specific date with 100% certainty. On the other hand, one might understand that some portion of the portfolio might be called upon with some likelihood over some reasonably narrow time frame. Generally speaking, the shorter the time horizon, the greater the likelihood funds might be needed and/or the larger the proportion of the investment portfolio actual or potential funding needs represent, the less exposure to market risk we suggest in a portfolio.



All Risky...To Varying Degrees

This approach accepts the fact that we must accept some amount of investment risk in exchange for any expectation of return in excess of that available from cash investments. And that risk will translate both into potentially heightened day-to-day, week-to-week, month-to-month (etc...) volatility, and more substantial potential drawdowns. Thankfully, while we cannot be sure that the future will look anything like the past in terms of *magnitude*, market history can give us a reasonable sense of what we should expect in terms of *relative* volatility under reasonably normal investment market and macroeconomic scenarios. That is, while we can't say how big market swings may be in the future, we can be pretty sure that the more stock we have in a

portfolio, the more volatile it likely will be. When it comes to choosing an appropriate portfolio for a given investment situation, we generally seek to balance the desire for return against the risk of not realizing that return over various time frames. For shorter-term scenarios that are focused on specific dollar needs, we want to be particularly sensitive to the potential for a realized loss over the investment time horizon. As we see in Figure 3, we should expect the range of investment outcomes over shorter time frames to be pretty wide. And that width expands as we add more stocks into the portfolio. This remains true over longer periods of time. We find the use of such views of market history in the context of the present investment environment useful tools as we help clients make investment-related decisions.



Indicative, Not Predictive

Of course, investment environments such as that in which we’ve been living since the COVID-19 virus spawned a pandemic demonstrate that the universe sometimes conspires to present particularly abnormal macroeconomic and investable market scenarios. The volatile first and second quarters of 2020 demonstrate that one must be careful to assume reasonably stable pricing for any investment over shorter time frames, even the “safest” government and corporate bonds.

As importantly, though, the second half of 2020 demonstrates the virtue of patience when it comes to investments with longer-term time horizons. Of course, investment markets will be volatile over shorter-, even medium-term time frames. And we should not forget that it doesn’t necessarily take a crisis on the order of a global pandemic to see risky investments lose 5%, 10% even 20% of their value over shorter-term time frames (see Q4 2018 as a fine example). But, with reasonably outward-looking perspectives, we might take

on investment risk in order to lift our return expectations. The key decisions here, then, shift more heavily to the second aspect of determining appropriate levels of exposure to market risk: willingness.

Patience May Be Required

We invest because we wish current savings to fund a larger amount of future spending. Connecting the two buckets generally requires the assumption of some amount of investment risk. The more return we seek, the more risk (volatility and interim drawdown) we likely will experience along the way. With all manner of risk, one must assume some likelihood that the value of invested monies will be lower at some point in the future than they are in the present. The question one must seek to answer...best as one can...is how well one might be able to persevere market drawdowns—meaning staying true to an investment exposure planned earlier when the value of the portfolio is smaller than it once was.

In market history we can find valuable indications of the range of investment outcomes we might experience. And investors can use those data—and, over time, their own personal experience—to gauge how much of an interim drawdown they'd be willing to tolerate over a particular investment time horizon. Given proximity to all-time stock market peaks, there's no time like the present to find an appropriate balance of expected reward and risk as we await the next bout of market instability.

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The Bloomberg Barclays U.S. 1-5 Year Government/Credit Bond Index, which is a broad-based benchmark that includes investment grade, U.S. dollar-denominated, fixed-rate Treasuries, government-related and corporate securities with maturities between 1 and 5 years.

One cannot invest directly in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio.

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