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3D Portfolio

Engineering a Three-Dimensional (3D) Asset Allocation for an Investment Portfolio: Balancing 1) Income, 2) Growth, and 3) Stability

Abstract

This white paper explores three dimensions of asset allocation in an investment portfolio: income, growth or capital appreciation, and stability or capital preservation. It delves into the competing nature of these focuses and highlights how an imbalance in one dimension can affect the others. The paper emphasizes the importance of striking a balance based on individual investors' age, goals, and risk tolerance. Furthermore, it provides examples of asset classes and investment styles that align well with each focal point, including stability, income, and growth.

Introduction

The asset allocation of an investment portfolio plays a crucial role in achieving financial objectives. While different investors have varying priorities, three primary dimensions shape the allocation decisions: income, growth, and stability. This paper aims to examine the interplay between these dimensions and demonstrate the need for a balanced approach.

Income Focus

An income-focused portfolio emphasizes generating regular cash flow from investments. It is often favored by retirees or individuals seeking consistent income streams. Asset classes that align well with this focus include:

- Dividend-Paying Stocks: Companies with a history of stable dividend payments. While dividend paying stocks are more volatile then bonds or fixed annuities, dividend stocks have historically been a great hedge against inflation over long periods of time.
- Bonds: Government and corporate bonds that offer regular interest payments. A bond is a loan. For example: An investor purchases $10,000 worth of IBM bonds that mature in five years and pay a 6% coupon. The investor would in essence loan IBM $10,000.00 and be paid $600.00 per year for five years and then receive his or her $10,000 principal back in five years, assuming IBM doesn't default or go out of business.

- Tax Free Municipal Bonds: Tax free municipal bonds provide income and are federally tax exempt and tax exempt in the state they are issued. An added benefit is that tax free municipal bonds have virtually no correlation to US stocks.
- Preferred Stocks: They typically provide higher income than common stocks and are purchased for their yield more so than capital appreciation. They are higher in the capital structure to the common stock and are junior to the corporate debt.
- Real Estate Investment Trusts (REITs): Properties that generate rental income for investors. There are private REITS as well as public REITs. Private REITS tend to have a lower standard deviation and are less correlated to the major stock indices, but are more illiquid and typically only available to accredited investors. Often real estate is thought of as a hedge against inflation.
- High-Yield Bonds: Debt instruments with higher interest rates but higher credit risk.
- Utility Stocks: this sector of stocks typically has higher dividends and is more mature and stable than most stocks and can include gas, electric, cable, and telecommunications companies.
- Annuities: They provide an income stream guaranteed by an insurance company for conservative investors who are looking for a guarantee.

Growth or Capital Appreciation Focus

A growth-focused portfolio aims to maximize long-term capital appreciation. Investors with longer investment horizons and a higher tolerance for risk often prioritize this dimension. Appropriate asset classes and investment styles include:

- Growth Stocks: Companies with high growth potential or innovative technologies.
- Dividend Growth Stocks: Stocks that pay a dividend and consistently raise their dividend are a proxy for stocks that consistently raise their earnings as well as growing their dividend. Often these "dividend growth stocks" tend to have very attractive capital appreciation over time.
- Convertible Bonds: A hybrid between a stock and a bond. All else being equal, convertibles tend to have greater stability than stocks for three reasons: 1) convertibles have a maturity date, 2) convertibles pay a coupon (besides zero coupon convertibles), and 3) convertibles have a bond floor (the price for which the convertible is pricing the conversion option at zero and now trades like the straight bond from the same issuer.)
- Growth-Oriented Mutual Funds: Funds that focus on capital appreciation by investing in growth-oriented stocks.
- Private Equity: Invests in companies that are not available to purchase on the open market and are typically smaller in capitalization and value priced. Private Equity investing is reserved for accredited investors only and typically as a "satellite strategy" to compliment a greater portfolio.

Stability or Capital Preservation Focus

A stability-focused portfolio prioritizes capital preservation and aims to minimize volatility and downside risk. It is typically favored by conservative investors or those nearing retirement. Asset classes and investment styles suitable for stability include:

- Treasury Bonds: Issued by governments and considered low-risk investments.
- Blue-Chip Stocks: Shares of large, well-established companies with a history of stability.
- Defensive Sectors: Industries that tend to perform well in economic downturns, such as consumer staples and utilities.
- Diversification: Spreading investments across various asset classes to reduce risk.
- Fixed Annuities or Fixed Indexed Annuites: A fixed annuity will keep a stable value and pay out a fixed amount of interest over a fixed amount of time and be guaranteed by an insurance company. A fixed indexed annuity is also issued by an insurance company and guarantees the principal, but the appreciation or income is based on an index return such as the S&P 500, credited up to a cap or limit.

Balancing the Three Focuses

While each focus has its merits, an excessive emphasis on any one dimension can lead to trade-offs and potential compromises. For instance:

- A high level of income may compromise capital appreciation and stability.
- A high level of capital preservation may result in low income and limited capital appreciation.
- A high level of capital appreciation may come at the expense of income and stability.

Investors should carefully consider their age, financial goals, and risk tolerance to strike a balance that aligns with their specific circumstances.

Conclusion

The asset allocation of an investment portfolio should consider the three dimensions of income, growth, and stability. While these focuses compete with one another, a balanced approach is necessary to achieve optimal results. By understanding the trade-offs involved, investors can select asset classes and investment styles that best suit their individual goals, risk tolerance, and investment horizons. Regular reassessment and adjustment of the portfolio's asset allocation is crucial to ensure it remains aligned with evolving circumstances and objectives. The examples above for the three (3) goals of income, growth, and stability are illustrative but not exhaustive.

This white paper is for informational purposes only and does not constitute financial advice. Investors are encouraged to consult with a qualified financial advisor before making any investment decisions

Asset allocation and diversification are investment methods used to help manage risk. They do not guarantee investment returns or eliminate risk of loss including in a decling market.

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