Whether you’re constructing a portfolio for the first time or reviewing it to determine whether adjustments are needed, you want to make sure the end result fits your comfort with risk and long-term financial goals. By focusing on quality and diversification using a wide variety of asset classes and rebalancing them regularly, you can build and maintain a solid portfolio designed to help withstand the market’s swings over time.

Just like a cook follows a recipe, we think it’s important to construct your portfolio by following a strategy that combines a wide variety of investments in the appropriate proportions for you. Your mix of investments needs to be based on your goals and comfort with market volatility, and personalized for your situation. In addition to periodic adjustments to keep your portfolio well diversified, you may need to make changes over time as your circumstances and goals change. Diversification does not guarantee a profit or protect against loss in declining markets.

The Blueprint for Diversification
Start with the decisions that can have the biggest impact on your long-term results – the mix of equity (stocks) and fixed income (bonds). At the left of our investment pyramid, equity investments are shaded green, and fixed-income investments are shaded gray. Since stock and bond prices often move in opposite directions, combining them may help reduce the volatility of your portfolio overall.

As you work with your financial advisor to determine the mix of stocks and bonds that align your portfolio with your goals, our Investment Policy Committee’s (IPC’s) investment pyramid can help you organize your decisions and understand how a wide variety of asset classes play particular roles in an appropriately diversified portfolio.

1 Alternative investments and stocks trading less than $4 align with the Aggressive investment category, but they are not recommended.
In addition to separating equities from fixed-income investments, the investment pyramid groups similar asset classes into investment categories, showing which domestic and international equity investments are more volatile (higher in the pyramid) and which are less volatile. Because the asset classes in fixed income and cash are generally less volatile, they’re shown lower in the pyramid.

We think your portfolio should include appropriate proportions of all of the investment categories and asset classes to stay prepared for the variety of market conditions you’ll experience over time. Although investments in an investment category or the same asset class tend to move together, they don’t always rise and fall in lockstep – they aren’t perfectly correlated – which is why your portfolio needs to be diversified within each asset class as well as across asset classes.

**Asset Classes Are Key Ingredients**
Each asset class plays a specific role in your portfolio, so it’s important to consider including all of them and understanding how they fit together. More volatile asset classes generally provide higher returns. In addition, they may help reduce the swings in your portfolio’s value because they tend to react differently to market and economic events, outperforming and underperforming at different times. As a result, more volatile asset classes have been less correlated with U.S. large-cap stocks than other growth and income investments. In general, including more asset classes in your portfolio can help improve the consistency of its performance as well as help provide better risk-adjusted performance versus owning just a few investments.

Further emphasizing the importance of diversification, additional portfolio construction considerations are highlighted to the right of the investment pyramid. We have specific recommendations for spreading your investments across a variety of sectors and securities. Owning too much in a single sector, stock or bond increases your portfolio’s sensitivity to the specific risks and performance of that investment, increasing the chances of unexpected results.

**Understanding Asset Class Risk and Return**
The chart below shows the 10-year average return and risk (standard deviation) of the asset classes we recommend including in your portfolio. In general, riskier asset classes also had higher average returns, showing that risk and return go hand in hand. The historical performance of each asset class provides some insight, but it’s not enough. Constructing and maintaining a well-diversified portfolio also requires understanding correlations as well as other considerations.

### 10-year Risk and Average Annual Return of Different Asset Classes

<table>
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<tr>
<th>Fixed-income Investments</th>
<th>Equity Investments</th>
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<tr>
<td>U.S. Inv.-grade Bonds</td>
<td>U.S. Large-cap</td>
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<tr>
<td>Cash</td>
<td>U.S. Mid-cap</td>
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<tr>
<td>Int’l Bonds</td>
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<td>High-yield Bonds</td>
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<td>Int’l High-yield Bonds</td>
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<tr>
<td>Cash</td>
<td>Emerging-markets</td>
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</tbody>
</table>

Source: Morningstar Direct, 1/1/2010 – 12/31/2020. 10-year annualized return. Vertical placement shows return – the higher the asset class, the higher the return. Horizontal placement shows risk – the farther to the right, the higher the asset class risk. Cash represented by the Barclays U.S. Treasury Bellwethers 3Mon Index. U.S. investment-grade bonds represented by the Barclays U.S. Aggregate Bond Index. High-yield bonds represented by the Barclays U.S. HY 2% Issuer Cap Index. International bonds represented by the Bloomberg Barclays Global Aggregate Ex USD Hedged. U.S. large-cap stocks represented by the S&P 500 Index. REITs represented by the FTSE Nareit All Equity REITs Index. Developed international large-cap stocks represented by the MSCI EAFE NR Index. U.S. mid-cap stocks represented by the Russell Mid Cap Index. U.S. small-cap stocks represented by the Russell 2000 Index. International small- and mid-cap stocks represented by the MSCI EAFE SMID. Emerging-market stocks represented by the MSCI EM Index. Commodities represented by the Bloomberg Commodity Index. International high-yield bonds represented by the Bloomberg Barclays Global High Yield USD Index. Past performance does not guarantee future results. An index is unmanaged and is not available for direct investment.
• **Higher returns mainly reflect higher risk** – Equity investments generally had higher average returns over the past 10 years than fixed-income investments. High-yield bonds were an exception, but they also provide less portfolio diversification than other fixed-income investments because they have a higher correlation with equities than fixed-income investments.

• **Riskier small- and mid-cap stocks had mixed performance** – Domestically, more volatile small- and mid-cap stocks slightly lagged U.S. large-cap stocks as a result of their lower exposure to the tech sector. Internationally, riskier developed international small- and mid-cap stocks had higher returns than developed international large-cap stocks.

• **International equity investments lagged** – Domestic and international equity investments tend to move differently, which is why owning both is important for portfolio diversification. But as a group, international equity investments had lower returns than similarly risky domestic investments, as the rest of the world rebounded more slowly from the 2008 global financial crisis and the U.S. dollar rose 2.1% annually. In previous decades, however, international equities have outperformed U.S. stocks, and international equity investments have frequently outperformed after past times when they’ve lagged.

• **Realistic expectations** – Over the past 10 years, markets were rebounding from the financial crisis, so returns for all asset classes were generally higher than what we expect over the next 10 years based on current valuations and conditions.*

As the economy and markets grow over time and prices vary up and down, the expected risk and return of each asset class will change. As a result, you may need to reduce asset classes that have outperformed and add to those that have underperformed and make other adjustments. That’s why your financial advisor uses a consistent process and sophisticated tools when working with you to select and adjust your portfolio over time.

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**What’s Your Strategy?**

Our investment pyramid provides the recipe for carefully combining a variety of investment categories and asset classes to construct your investment portfolio. It is designed to help provide solid diversification and better risk-adjusted performance over time.

Including investments with higher price volatility or with poor recent performance can help reduce the swings in your overall portfolio’s value because they frequently move differently from other investments. But owning a wide variety of asset classes also means you’re almost always going to be disappointed by at least one of your investments. That’s a sign your portfolio is well-diversified. And remember that if your portfolio is overly concentrated in one investment, sector, asset class or investment category, you may be taking more risk than you realize.

Your strategy is designed to help you invest without taking unnecessary risks. That’s why we recommend building a portfolio of quality investments with the right mix of equity and fixed income for your comfort with risk, time horizon and goals. Your portfolio is also likely to change over time as your life changes and markets move. Following your personalized strategy and partnering with your financial advisor can help you stay on track toward your goals over time.

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*Past performance is not a guarantee of how the markets and asset classes will perform in the future.

Investors should understand the risks involved of owning investments, including interest rate risk, credit risk and market risk. The value of investments fluctuates, and investors can lose some or all of their principal.

Special risks are inherent to international investing, including those related to currency fluctuations and foreign political and economic events.