
No Portfolio is an Island



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This Presentation Will Cover...

- ▶ Different types of risks to consider when building portfolios that are more efficient for clients when viewed from a total wealth perspective
- ▶ Understand why there is no one efficient portfolio for all investors
- ▶ Frameworks for incorporating different risks and preferences into the portfolio optimization process

5



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*No man is an island,
Entire of itself,
Every man is a piece of the continent,
A part of the main*

John Donne, 1624



6



6

Total Wealth Research

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7



7

Agenda

The Impact of _____ on Efficient Portfolios

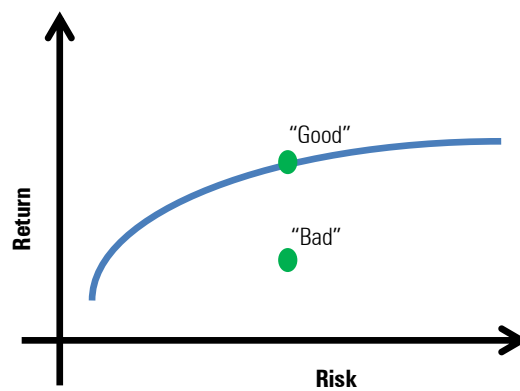
- ▶ Total Wealth
- ▶ The Goal
- ▶ an Income Focus
- ▶ Taxes
- ▶ Time

8

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How Efficient is Your Portfolio?



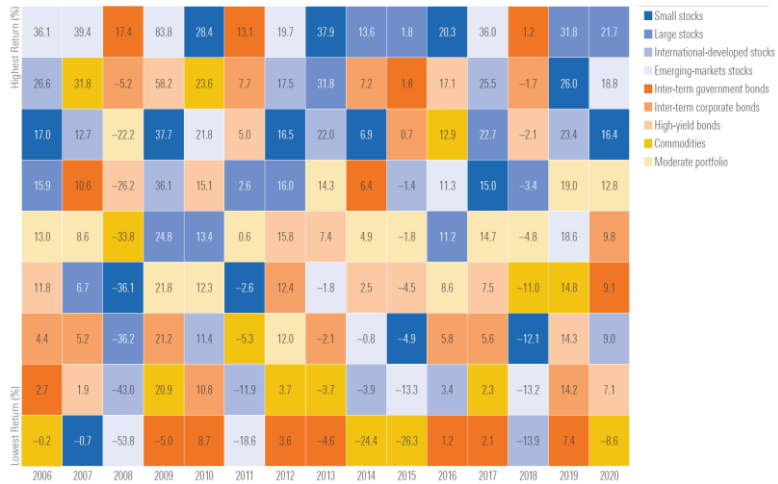
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Diversification... The Only Free Lunch



10



10

One Size Does Not Fit All



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11

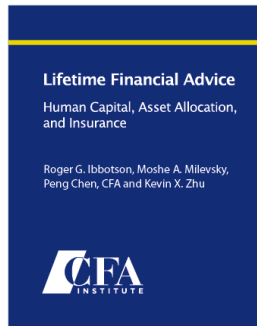


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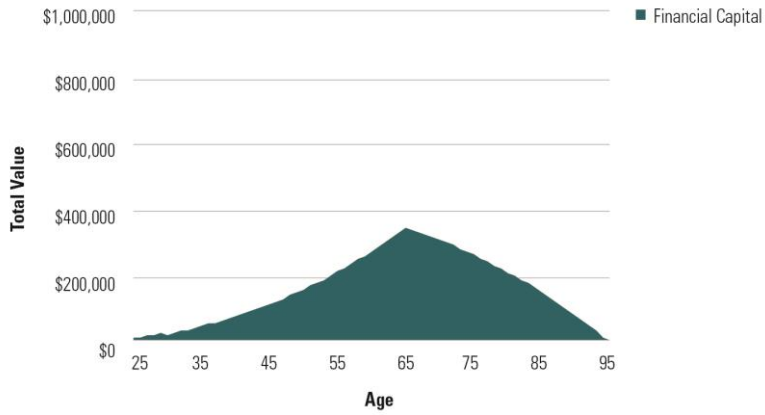
A Total Wealth Perspective (Households)



Total Wealth Research



Typical "Wealth" Perspective



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14



14

Two Sides to the Equation



Assets



Liabilities

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15



15

No Portfolio is an Island



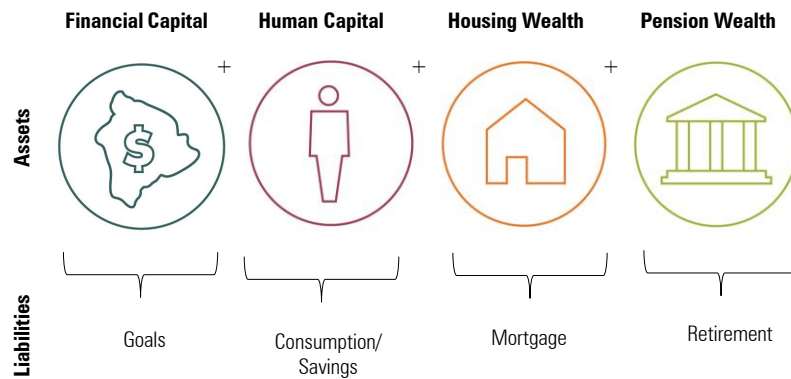
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16



16

Total Wealth Components (for a Household)



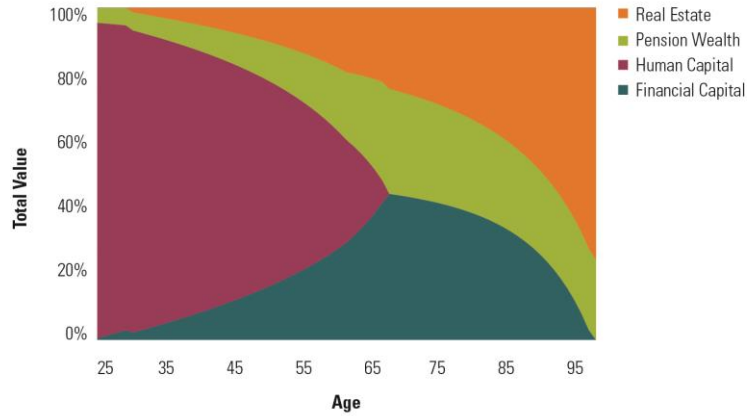
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17

Total Economic Worth (Relative Weights)



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18



18

A Better Balance Sheet

Exhibit 2 Economic (Holistic) Balance Sheet as of 31 December 2014			
Assets		Liabilities	
Financial capital	€4,020,000	Debts	€640,000
Liquid assets		Credit card debt	
Investment assets		Car loan	
Personal property		Home mortgage	
		Home equity loan	
Human capital	€1,400,000	Lifetime consumption needs (present value)	€4,200,000
Pension value	€500,000		
		Bequests	€400,000
Total Assets	€5,920,000	Total Liabilities	€5,240,000
		Net Wealth	€680,000

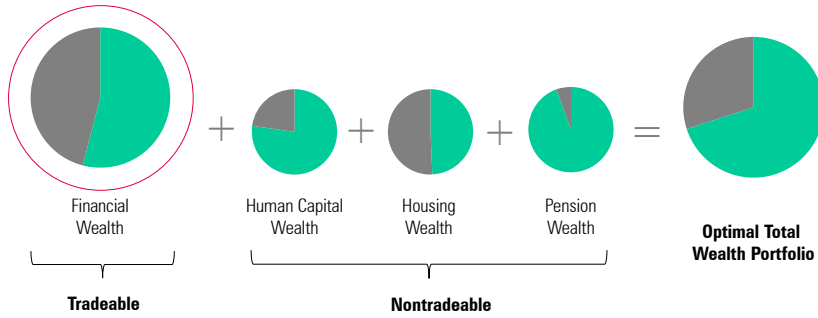
Source: Private Wealth Management: Risk Management for Individuals. CFA Curriculum by David Blanchett, David Cordell, Michael Finke and Tom Idzorek.

19



19

Using Financial Wealth as a Completion Portfolio



Source: "No Portfolio is an Island." by David Blanchett and Philip Straehl in the *Financial Analysts Journal*

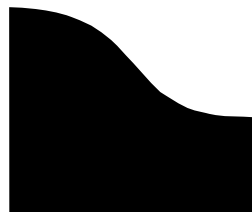
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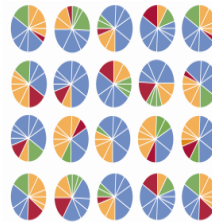
20

Dual Impact

Equity Target



Asset Allocation



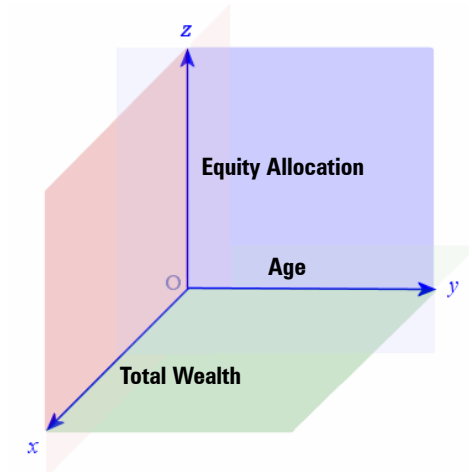
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21



21

Efficient Total Wealth Portfolios



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22



22

Human Capital

23



23

Human Capital Matters

- ▶ *Human capital theory supports a significant commitment to equities for young individuals, declining to a more modest allocation as one approaches retirement and eventually leaves the workforce.*
 - Vanguard’s Approach to Target-Date Funds
- ▶ *We consider participants’ ability to earn income and save—their human capital—to be a critical component of their total portfolio.*
 - SSgA Custom Target Date Funds
- ▶ *For a vast majority of households, human capital and its role in an investor’s wealth are critically important.*
 - Merrill Lynch Target Date Asset Allocation Methodology

24

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Human Capital: What Can Possibly Go Wrong?



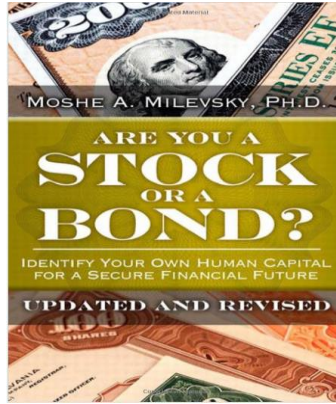
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How Risky is Human Capital?



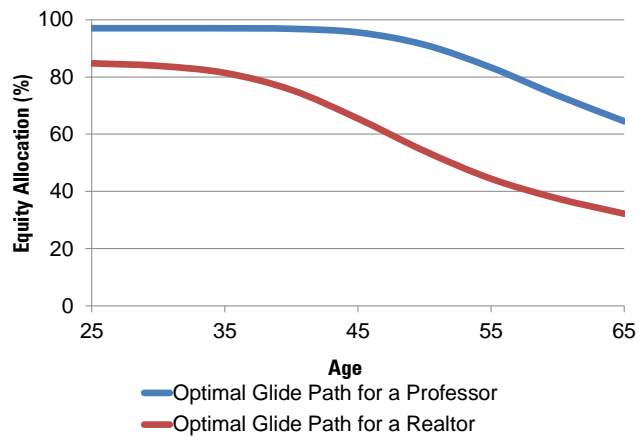
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26



26

Examples of Optimal Glide Paths for Different Jobs



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27



27

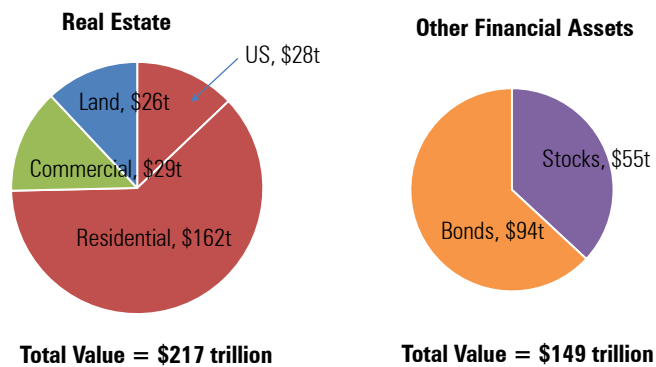
Residential Real Estate (Homes)

28



28

The Relative Value of Real Estate



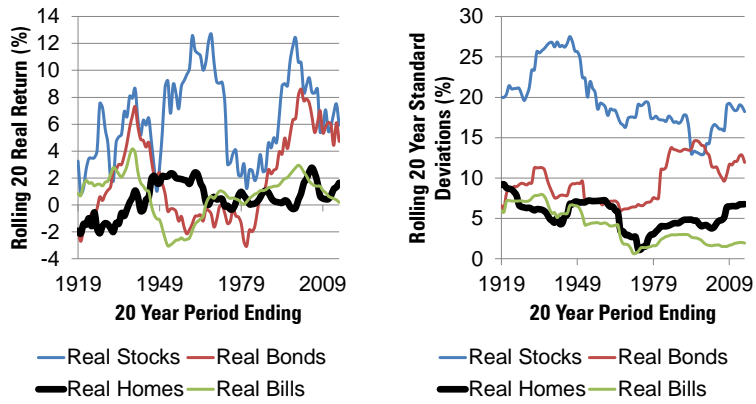
Source: "Your Home as an Investment." by David Blanchett. Morningstar White Paper.

29



29

Historical Real Returns and Risk



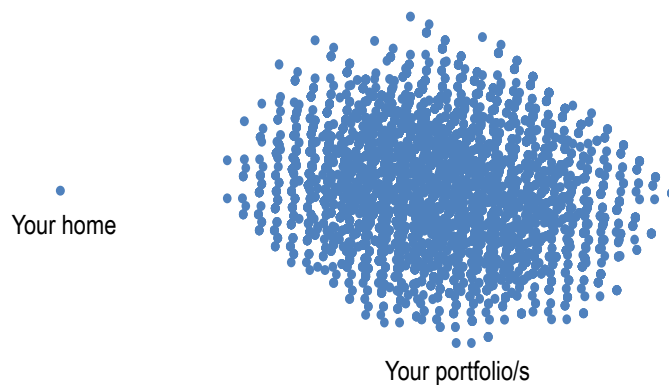
Source: "Your Home as an Investment." by David Blanchett. Morningstar White Paper.

30



30

The Risk of Homeownership



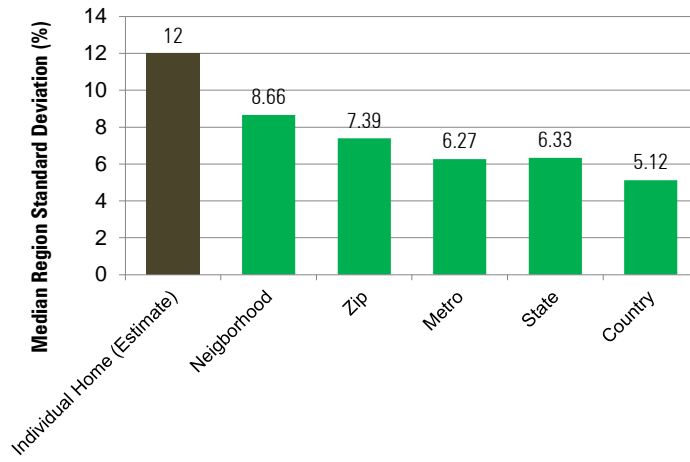
Source: "The Home as a Risky Asset." by David Blanchett. *Journal of Personal Finance*

31



31

Differences in Annual Home Price Volatility by Region-Size



Source: "Your Home as an Investment." by David Blanchett. Morningstar White Paper.

32



32

Pensions

33



33

The Largest Asset of Most Retirees

- ▶ Where is it on your/their balance sheet?



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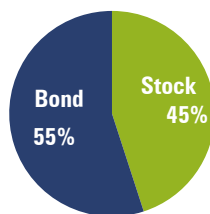
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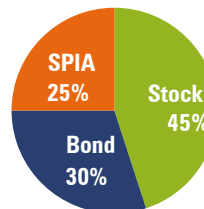
34

Thinking About Guaranteed Income

Target Allocation



Adding Guaranteed Income



- ▶ The remaining non-annuity portfolio now has a 60% equity allocation; however, the total wealth allocation from an income perspective, after considering the Single Premium Immediate Annuity (SPIA), is still 45% equities.

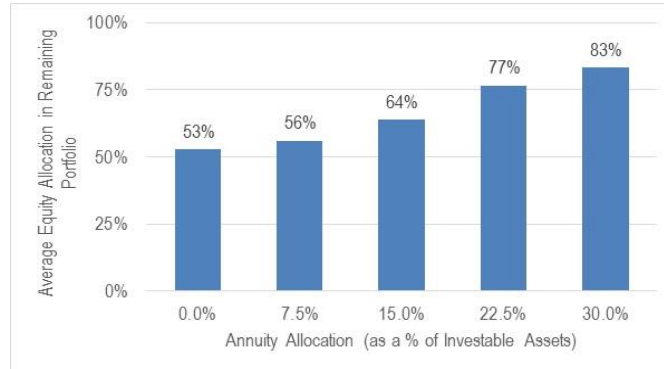
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Portfolio Impact of Guaranteed Income



(more guaranteed income = more aggressive portfolios)

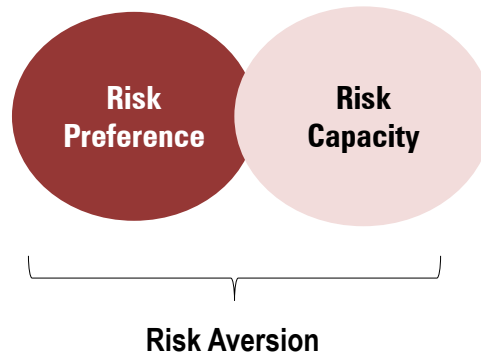
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36



36

Risk Capacity vs Risk Preference



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37



37

The Importance of Holistic Planning

Collect Inputs



Human Capital



Financial Capital
and Current Savings



Life Insurance and Annuities

Determine Asset Allocations



Traditional Funds, ETFs



Life Insurance/Annuities

38



38

Liability-Relative Investing (for Individuals)

39



39

What is the Goal?



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40



40

Improving Portfolio Health



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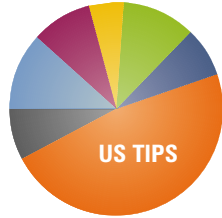
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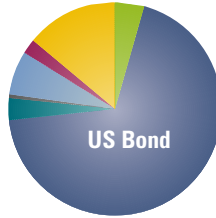
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Different Efficient Portfolios

Retirement Focused



Accumulation Focused



- Cash
- US Bond
- Non US Bond
- US TIPS
- US Large Cap Stock
- US Small Cap Stock
- Non US Large Cap Stock
- Emerging Markets Stock

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42



42

Efficient Income Investing

43



43

An Income Perspective

- ▶ Limited guidance on how to build an efficient income portfolio
- ▶ Traditional portfolio optimization research focuses on Total Return (which combines Price Return and Income Return), which is an incomplete perspective for a retiree who wants to generate income and not liquidate principal
 - ▶ Example: Long-Term bonds held to maturity

44



44

Income Return, Price Return, and Total Return

Asset Class	Income Return		Price Return		Total Return	
	Return	Std Dev	Return	Std Dev	Return	Std Dev
Short-term Bond	3.80%	1.36%	0.00%	2.13%	3.80%	2.73%
Intermediate Govt	3.83%	1.41%	0.00%	3.81%	3.83%	4.19%
Long Govt	4.05%	0.97%	0.00%	11.24%	4.05%	11.80%
High Yield	6.84%	0.69%	0.00%	14.73%	6.84%	16.12%
International Bond	6.01%	1.62%	0.65%	8.78%	6.66%	9.17%
Emerging Markets Bond	7.03%	2.90%	0.76%	13.52%	7.79%	14.65%
Large Growth	1.50%	0.44%	8.53%	22.40%	10.03%	22.73%
Large Value	2.65%	0.49%	6.92%	17.02%	9.56%	17.53%
Small Growth	0.62%	0.13%	11.07%	22.59%	11.69%	22.74%
Small Value	2.11%	0.28%	7.94%	17.88%	10.05%	18.22%
Preferred Stock	7.50%	0.78%	0.00%	12.74%	7.50%	13.99%
Non-US Large Growth	2.59%	0.56%	9.25%	21.83%	11.84%	22.34%
Non-US Large Value	4.07%	0.92%	7.87%	21.93%	11.93%	22.57%
Emerging Markets Equity	2.60%	0.50%	10.62%	35.65%	13.22%	36.53%
Non-US Real Estate	4.20%	0.47%	8.46%	28.60%	12.66%	29.83%
US Real Estate	3.00%	1.38%	7.67%	19.57%	10.67%	21.19%

Source: "Efficient Income Investing" by David Blanchett and Hal Ratner in the *Journal of Portfolio Management*

45



45

Decomposing the Efficient Frontier



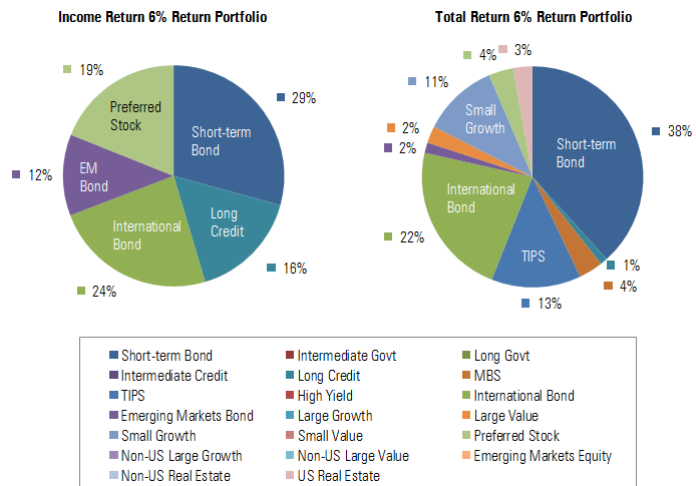
Source: "Efficient Income Investing" by David Blanchett and Hal Ratner in the *Journal of Portfolio Management*

46



46

Different Efficient Portfolios



Source: "Efficient Income Investing" by David Blanchett and Hal Ratner in the *Journal of Portfolio Management*

47



47

Taxes

48

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Who Likes Paying Taxes?



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Taxes Aren't Always a Bad Thing...

15%

Today

35%

Tomorrow

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The "Cost" of Taxes (Finding Tax Alpha)

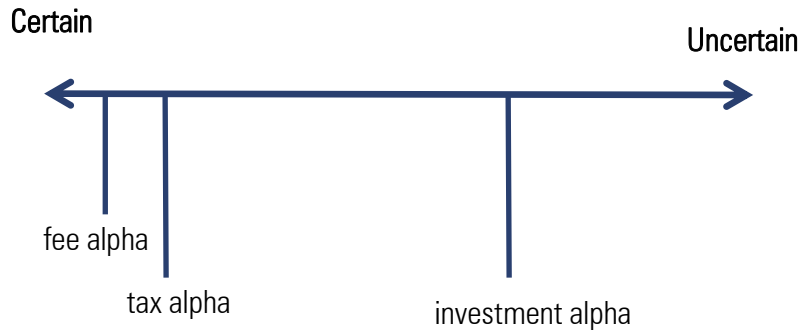
- ▶ Future earnings on taxes paid
- ▶ Paying a higher potential tax rate

51

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Generating Alpha



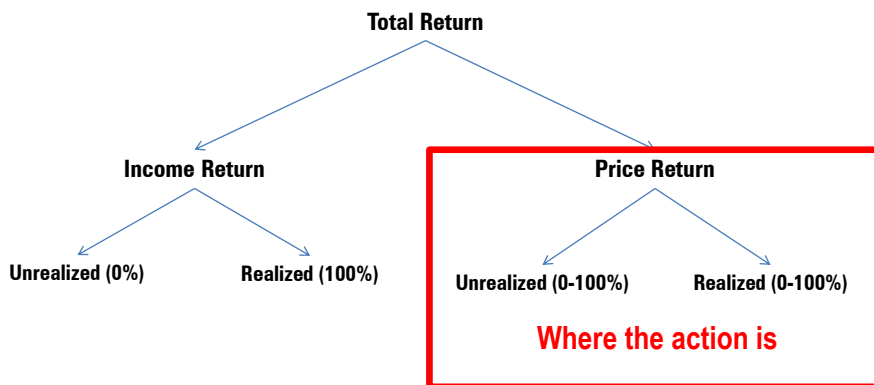
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52



52

Decomposing Returns



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53



53

Impact of Taxes on Relative Fund Performance

- ▶ Index funds generate 25 bps of tax alpha, on average, versus all active funds
- ▶ Tax alpha for an index can easily exceed 100 bps for an “active” actively managed fund
 - ▶ This creates a relatively high hurdle for an active manager to overcome in the taxable space

54



54

Sample Optimization Inputs

Asset Class	Before Tax		After Tax		Change	
	Return	Std Dev	Return	Std Dev	Return	Std Dev
Large Cap Equity	7.8%	18.8%	6.2%	16.4%	80%	87%
Mid Cap Equity	8.7%	20.3%	7.1%	17.7%	81%	87%
Small Cap Equity	8.6%	24.2%	7.0%	21.0%	81%	87%
International Equity	9.1%	20.7%	7.4%	18.2%	81%	88%
Emerging Markets Equity	12.3%	29.2%	10.4%	26.3%	84%	90%
US REITs	8.1%	23.5%	5.9%	23.4%	73%	100%
HY Bonds	5.2%	11.2%	3.0%	14.5%	58%	129%
Aggregate Bonds	3.4%	7.0%	2.2%	6.3%	65%	90%
Cash	2.0%	1.9%	1.3%	1.9%	65%	99%
TIPS	3.6%	7.0%	2.4%	6.3%	66%	90%

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55



55

Impact of Taxes on Optimal Equity Allocations

		Pre-Tax	Post-Tax	Δ
Total Return	4.50%	8.1%	9.2%	1.1%
	5.00%	11.9%	13.7%	1.9%
	5.50%	16.1%	19.2%	3.1%
	6.00%	20.0%	27.1%	7.1%
	6.50%	23.5%	32.6%	9.1%
	7.00%	27.1%	38.1%	11.0%

Source: "Efficient Income Investing" by David Blanchett and Hal Ratner in the *Journal of Portfolio Management*

56



56

Asset Location



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57



57

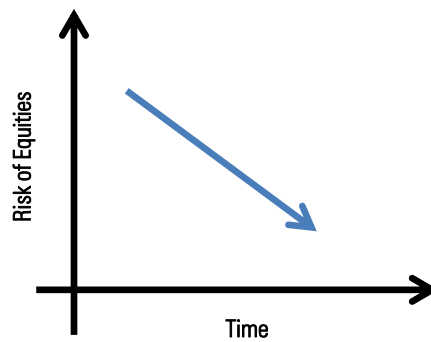
Optimal Portfolios for the Long Run

58



58

What is Time Diversification?



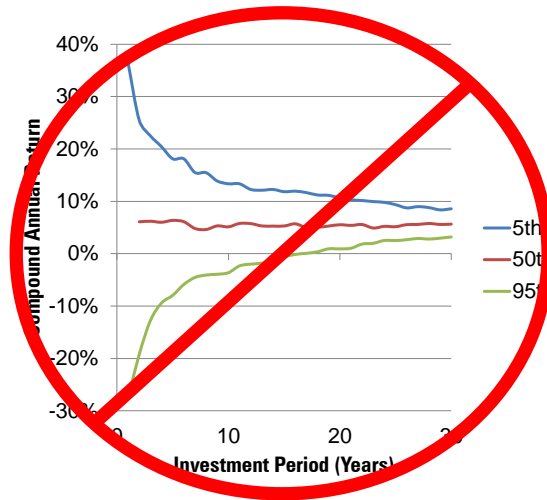
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59



59

Compound Annual Return of Equities by Investment Period



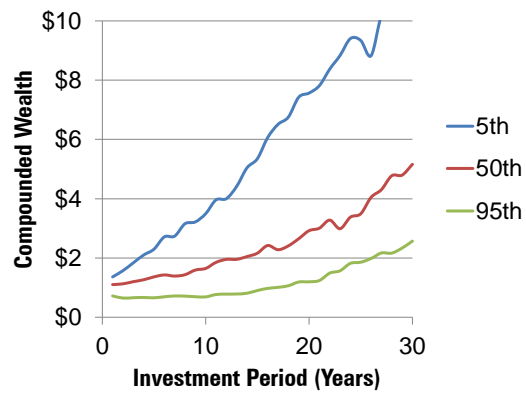
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60



60

Cumulative Wealth by Investment Period



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61



61

Time Diversification Debate



Zvi Bodie, Ph.D.
Boston University

"Having a long time horizon and being risk averse are two completely different things. The popular literature has basically said if you have a long time horizon you're tolerant towards risk. That's the fundamental fallacy."

Source: NAPFA 2004 Conference

"Stocks are relatively safer in the long run than random walk theory would predict. Doesn't mean they're safe. The whole point is that they are relatively safer... Does the fact that equity returns display long run mean reversion change your equity strategy? The answer is definitely yes. Change your allocation strategy? The answer is definitely yes."

Source: NAPFA 2004 Conference

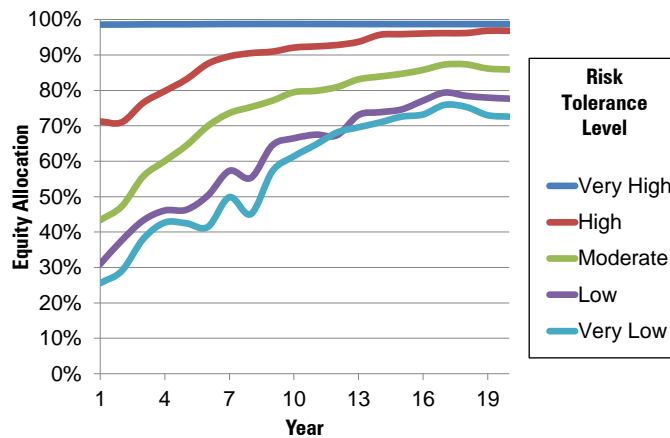


Jeremy Siegel, Ph.D.
Wharton School



62

Optimal Equity Allocation by Holding Period and Risk Tolerance Level



Source: "Optimal Portfolios for the Long Run" by David Blanchett, Michael Finke, and Wade Pfau. Morningstar White Paper.

63



63

Is Time Diversification Going Away? (No)

Optimal Equity Allocation for Short-term Investors



The optimal equity allocation for a moderately risk averse investor with a single period time horizon has decreased from ~50% to ~20%

Benefit of Time Diversification



The optimal change (increase) in equity allocation by investment time horizon has increased from ~1% to ~2.5%

Source: "Optimal Portfolios for the Long Run" by David Blanchett, Michael Finke, and Wade Pfau. Morningstar White Paper.

64



64

Framing Retirement Using Buckets

- ▶ Segment assets into accounts based on how long until the money is going to be needed



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65

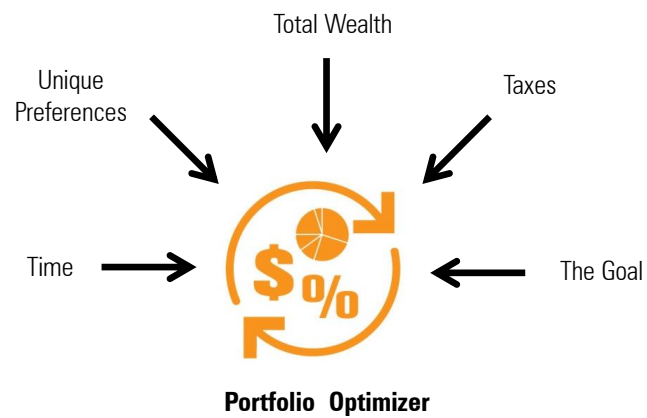
Conclusions

66



66

More Optimal “Optimized” Portfolios



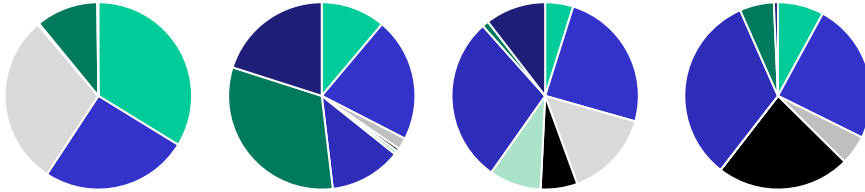
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67



67

Different Households, Different Efficient Portfolios



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68



68

True Alpha

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69



69

The Art and Science of Building Optimal Portfolios



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70

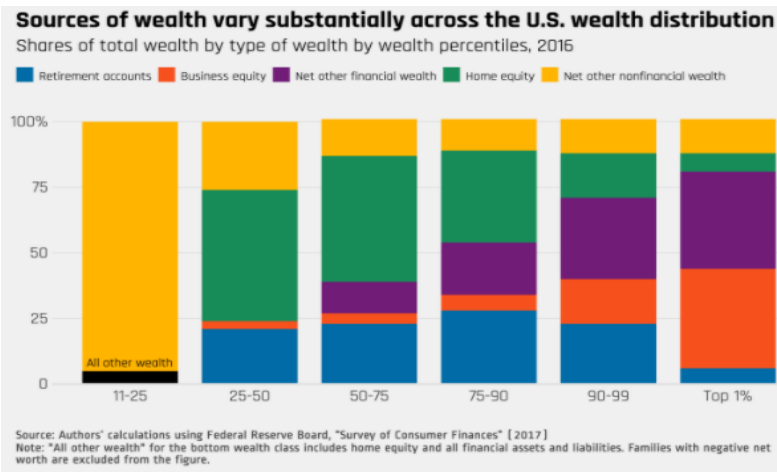


70

Homeowners with Tappable Equity

\$6.5 Trillion for Homeowners 62

Source: Black Night Analytics



71

There is no better time to consider a reverse mortgage!

- Rates are low!
- Values are high!

Let's look at an example:

- A 63-year-old with a free and clear 600k home.

- January 2019 principal limit: \$233,400
- January 2021 principal limit - \$306,600
- Turn this money into an income stream, utilize the line of credit option(remember it grows for future use), or take a lump sum distribution – TAX FREE AND NO PAYMENT IS REQUIRED!

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72

Thank You



Terry Hancock
National Reverse Mortgage Director, NMLS ID 448233

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90620 Branch NMLS 3277

About Terry

Terry joins us with over 44 years in the mortgage business and was the #1 Reverse Mortgage Specialist in So Cal at Fairway before he made the switch to Sun West. He resides in Temecula, CA with his wife of 37 years and two daughters and enjoys spending time with his family and all things "Boston" sports.

"I am looking forward to working with the branches to further develop the expertise needed to make Sun West a Top 10 lender in the Reverse Mortgage space," said Terry. And Pavan Agarwal is excited to have him on the team!

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73

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