the draft and diversification

what the football draft teaches us about portfolio diversification

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Every year, professional football teams enter the draft seeking to strengthen their rosters with new players and new skill sets to improve their chances of winning.

Football and investing have a lot in common. Football teams have a simple objective: Win by scoring points and defending the lead. Investing is no different: Reach your objective by achieving gains, and protecting those gains.

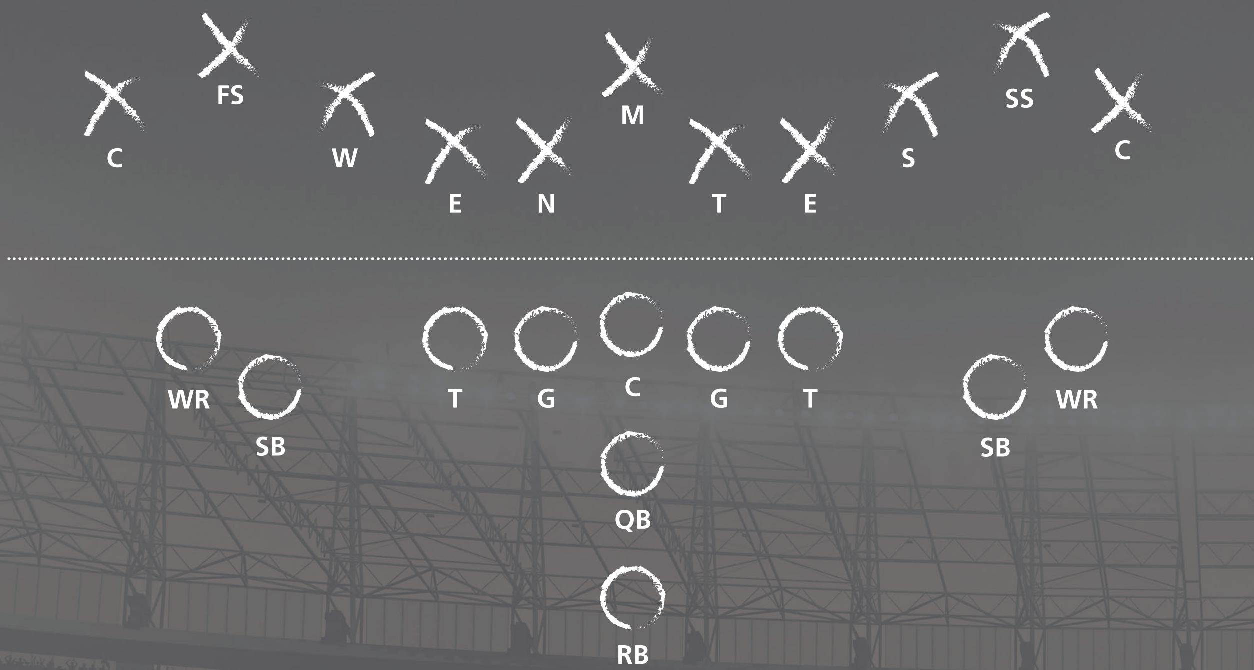
The draft process and investing also have notable similarities, with the draft providing some valuable lessons on portfolio diversification for investors facing a fierce opponent. That opponent is *uncertainty*, and it is becoming increasingly powerful, thanks to the unpredictable geopolitical environment and the return of whipsaw volatility to the equity markets.

Uncertainty wins when investors make poor, emotionally-driven investment decisions, like selling at the wrong time and missing out on the long-term benefits of the market that they need to achieve their objectives.

To elevate the chances that they can overcome uncertainty and achieve their objectives, investors might take a page out of football's playbook: On an annual basis, perhaps when football runs its draft, do your own portfolio assessment, and consider the following lessons drawn from the parallels between the draft and portfolio diversification.

2018 Asset Class Draft Guide

Drafting your portfolio? Here are the asset classes to consider for **OFFENSE**, **DEFENSE** and **SPECIAL TEAMS**.



OFFENSE

QB — **Quarterback**
US large cap growth equity

RB — **Running back**
REITS

C — **Center**
US large cap value equity

G — **Guards**
US mid cap equity
US high yield bonds

T — **Tackles**
International equity
Smart beta

SB — **Slot backs**
Small cap equity
Emerging market equity

WR — **Wide receivers**
International bonds
Emerging market bonds

DEFENSE

N/T — **Nose tackle/tackle**
Municipal bonds
Short-term treasuries

E — **Ends**
Cash
Long-term treasuries

M — **Middle linebacker**
Gold

S — **Strong linebacker**
US corporate bonds

W — **Weak linebacker**
G10 Sovereign debt

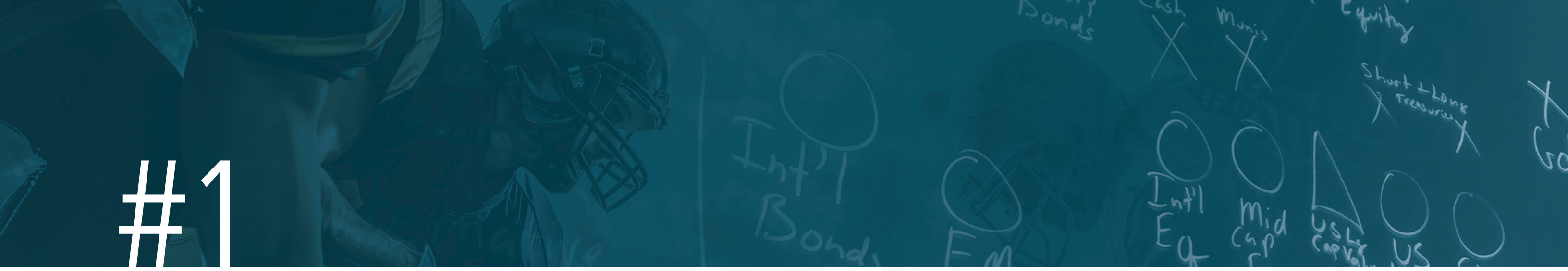
C — **Corners**
Preferred equity
TIPs

FS — **Free safety**
Low vol equity

SS — **Strong safety**
High dividend equity

SPECIAL TEAMS

Alternative strategies including market neutral, commodities, liquid real assets, infrastructure



#1

know your game plan.

To build a team capable of overcoming uncertainty, start by determining your game plan. In football terms, is your game plan built around an aggressive offense, a strong defense, or a balance of both?

An aggressive offense uses a high volume of downfield passes and deep routes, seeking big gains. Investors with an aggressive game plan are seeking growth and their portfolios include higher risk assets, such as growth stocks, small cap stocks, emerging market stocks, and high yield bonds.

Aggressive game plans can help investors take an early lead, but it's important to remember the insightful quote by Texas Coach Darrell Royal: "There are three things that can happen when you pass, and two of them are bad."

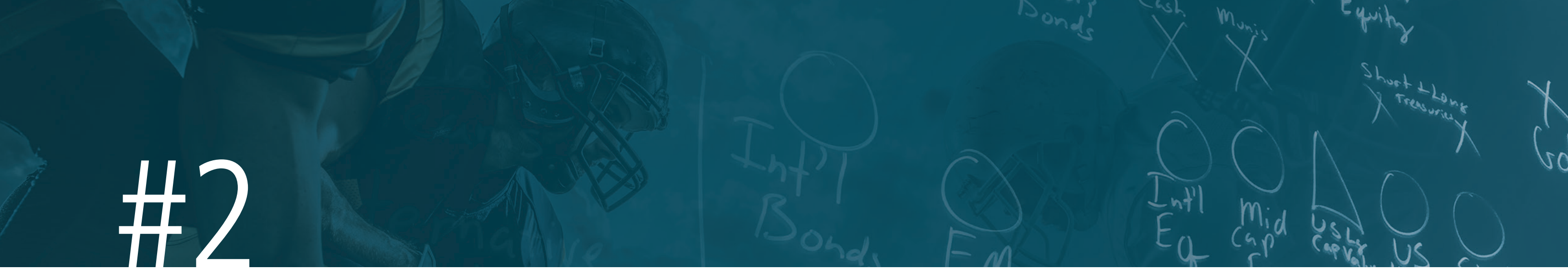
A more conservative game plan might feature a high propensity of running plays out of tight formations, moving the ball first down by first down, with the occasional pass. Investors following this game plan have objectives that include income or capital preservation, possibly with a modest amount of growth.

Investors with a lower-risk plan place far more emphasis on defense to protect their lead, with assets including investment grade and municipal bonds, defensive equities with high dividends and low volatility, and depending on how conservative, higher cash positions.

It's important to note that conservative game plans that seem less risky may run the risk of coming up short on the scoreboard. A defensive-minded team might also cause an investor to miss out on the potential for future market performance.

The Lesson

Every game plan has risks. Having clear objectives and the right game plan you're comfortable with will guide your portfolio diversification to help you conquer uncertainty.



#2 know your strengths and weaknesses.

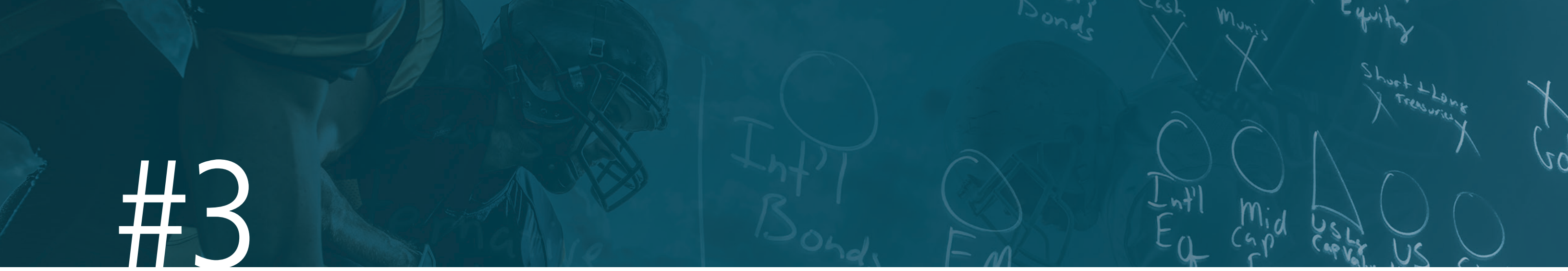
Knowing your team's strengths and weaknesses in executing your game plan is the key when making draft picks. The same holds true for investing.

Investors need to understand if they have the right assets in their portfolio, on both sides of the ball, to maximize their chances of overcoming uncertainty and achieving the outcome they seek – whether it's growth, income, capital preservation or a combination.

On offense, is your portfolio's equity allocation concentrated in just U.S. large cap stocks? Would a more diversified allocation that includes small cap and emerging market equities improve your chances of overcoming uncertainty? On defense, is your portfolio too conservative? Have you considered defensive equities such as low volatility, high dividend stocks that may reduce volatility while participating in gains? Is your fixed income allocation taking advantage of global opportunities; or, is it taking too much risk to reach for income? Do you have too much cash on the sidelines? Are you not taking enough risk – are your assets too conservative and are you running the risk that you come up short on the scoreboard?

The Lesson

It's important to know the strengths and weaknesses of every player in your portfolio, while also considering other assets that your portfolio might be missing, in order to achieve your ideal diversification.



#3

fortify your defense to protect your lead.

It's been said that offense wins games (and sells tickets), but defense wins championships. It's true, there's nothing as exciting as watching your team light up a scoreboard. Similarly for investors, little matches the excitement of an equity bull market.

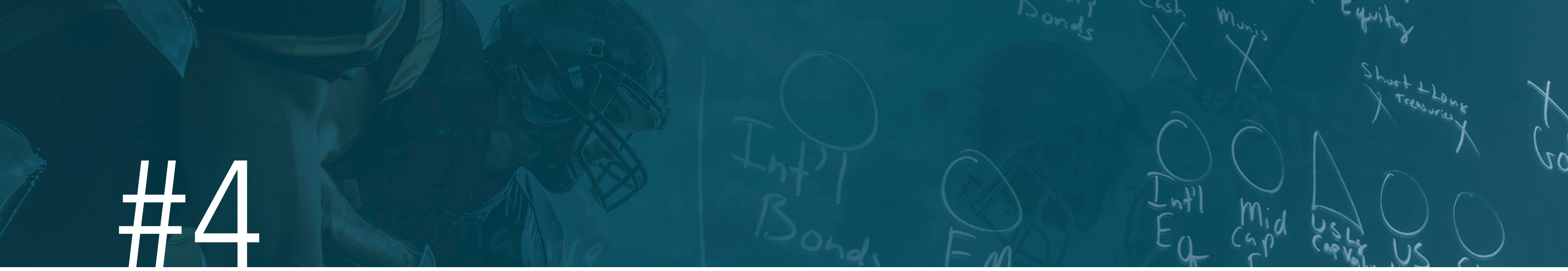
But what good is a lead if you can't protect it? Defeating uncertainty means not only defending the lead when you have it, it means avoiding a devastating loss in the form of a deep and damaging drawdown. Game plans that over-emphasize offense run the risk of a devastating loss.

Consider equity investors who have enjoyed the prolonged bull market – they may find themselves significantly over-weight in stocks thanks to capital appreciation. They are running a very aggressive offense but are weak on defense with little to protect their lead at a time when they have a lot to protect… and a lot to lose. This creates a significant weakness in their game plan that uncertainty can exploit.

Winning teams are strong on both sides of the ball. Investors all too often focus only on offense and do not have well-diversified portfolios that include a strong defense.

The Lesson

When drafting a portfolio, focus on offense and defense because once you take the lead, you need to defend it against uncertainty.



#4

don’t overlook special teams.

And then there are the all-important special teams. These are situation players who can be key drivers of performance on both offense and defense, and often are the difference between winning and losing.

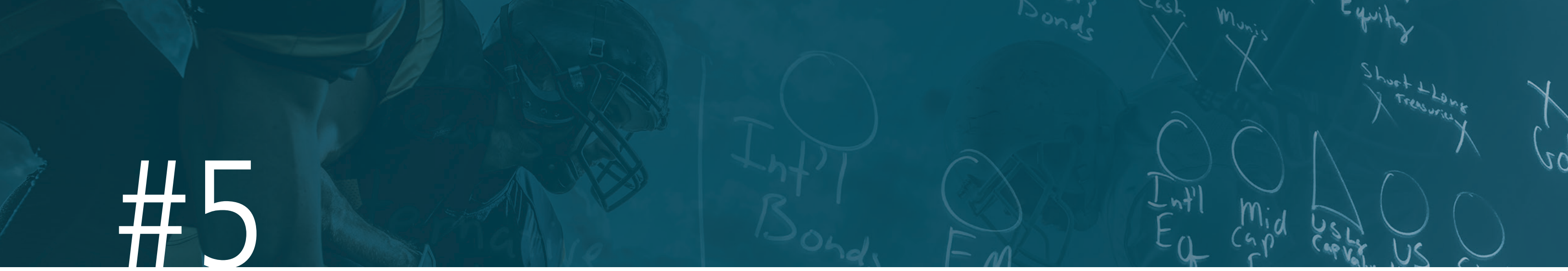
Who are they? Field goal and extra point kickers – kickers are the highest scoring players in professional football history. Kick return specialists are capable of adding significant alpha. Punters with great precision can be effective defensive assets, while kick coverage units are critical to preventing a sudden, disastrous turn of fate.

To investors, special team players are tactical assets used to take advantage of alpha generating opportunities, or to add a level of possible lead protection to a portfolio in times of increasing volatility.

These assets include market neutral strategies, commodities, liquid real assets and infrastructure.

The Lesson

Special teams offer unique opportunities to make short-term tactical decisions intended to add to or protect your gains. Don’t overlook them in your portfolio.



#5

teamwork and chemistry are critical.

Players are drafted based on numerous factors including how well they work with other players as teammates.

When it comes to investing, the same holds true: Well-constructed portfolios are diversified across assets that work together to elevate the certainty of success.

Consider how this might work on the defense: A defensive lineman has different skills and responsibilities than the safety. If the lineman doesn't put pressure on the opposing QB, that QB has time to throw – and that means the safety needs to step up and knock down or intercept the pass. In investment terms, the players are uncorrelated. They need to do their own job but also work together, as teammates with great chemistry, to back up each other or they can throw off the entire team.

The Lesson

Picking uncorrelated assets for their specific attributes that *also* work together is the essence of portfolio construction and may be the answer for overcoming uncertainty.

"Football is one third **OFFENSE**, one third **DEFENSE**, and one third **SPECIAL TEAMS**."

The legendary football coach George Allen is credited with this quotation. The same concept holds true for investing: The best way to conquer uncertainty is with a well-diversified portfolio that balances offense and defense and is enhanced by special teams.

Unfortunately, too many investors place too much emphasis on offense and overlook the benefits of other assets. Is your portfolio loaded with offense but weak on defense? Or, are you stacked with defense but missing out on the market and in need of a better offense?

Have you paid attention to the benefits of special teams at all? With the return of high volatility to the market, this is the ideal time to review your portfolio and draft the talent your team needs to try to defeat uncertainty, beginning with diversification.

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