STRATEGIC AND TACTICAL ASSET ALLOCATION

LAIRD NORTON WEALTH MANAGEMENT
INVESTMENT PROCESS
STRATEGIC AND TACTICAL ASSET ALLOCATION

INTRODUCTION

In building investment plans for our clients, we start with the decisions that impact our clients’ portfolios the most and then continue to make accretive decisions until the plan is complete. Empirical studies consistently demonstrate that asset allocation affects variances in investment returns more than any other factor, making it the most impactful decision we can make for a client’s portfolio. As such, we start here to develop our clients’ investment plans.

Asset allocation is the process of determining asset classes in which to invest and the percentage of the total portfolio that goes to each. When done well, it is a plan to invest in asset classes, and at the appropriate levels, that best meet the client’s needs.

Laird Norton Wealth Management (LNWM) constructs a total of 24 separate portfolio mixes comprised of six risk profiles across both taxable and tax-exempt account types, with alternative investments and without. While we understand that each client’s investment plan is unique, we attempt to customize their plan around one of our portfolio solutions that represent our best thinking.

We incorporate forecasted market and economic factors into our proprietary models to develop forward-looking risk and return assumptions for each asset class. We evaluate these assumptions on both a pre-tax and post-tax basis and optimize portfolios to volatility targets that align to our clients’ risk tolerances. We make long-term (strategic) allocation decisions and shorter-term (tactical) positioning based on our goal to design portfolios that align with our clients’ investment objectives. We also overlay our strategic allocations with tactical positions aimed to capitalize on shorter-lived market conditions. Our overall objective is to offer our clients superior investment performance with a heightened focus on risk management.

STRATEGIC ASSET ALLOCATION

THE FOUNDATION OF OUR CLIENTS’ INVESTMENT PLAN

LNWM believes that strategic allocation decisions should be made with a multi-year investment horizon in mind. While we do not necessarily subscribe to the philosophy of "buy and hold," we do believe that the investment objective of many managers

1. Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, "Determinants of Portfolio Performance", The Financial Analysts Journal, (July/August 1986) p. 39-44. This is a study which found that asset allocation explains more than 90% of the volatility of returns of an overall portfolio.
and asset classes needs a full market cycle (from peak to trough and back) or longer to come to fruition. The strategic allocation determined for each of our clients is the foundation of their overall investment plan.

We develop strategic investment targets for clients, taking into account both their risk tolerance and their long-term investment goals. Through conversation, questionnaires and sophisticated modeling, our client service advisors aid new clients in determining their priorities, identifying their appetite for risk and developing their investment goals.

At LNWM, we utilize a proprietary modeling system for developing forward-looking estimates of returns, volatility levels and correlations of asset classes in which our clients invest. These forecasts are based on a 10-year horizon to minimize the impact of short-term variations on our outcomes. In this proprietary model, we utilize a “building block” methodology whereby we construct an asset class’s forecasted return from a number of capital market variables, or factors. These factors include expectations for interest rates, inflation, GDP growth, dividend payments, currency exchange rates, and the like. These factors are additive to an asset class return expectation so we compile them together, like building blocks.

We parse return assumptions for each asset class into separate components for income, dividends and long-term or short-term capital appreciation. By segregating returns into these categories, we can designate a specific tax rate to each of the components and compose a list of both pre-tax and post-tax return assumptions. This segregation of return components is based upon historical and forecasted trends as well as our understanding of the tax sensitivity of our approved managers and the nature of the asset class.

Post-tax volatility assumptions are also generated for each asset class. Not only is volatility an important metric in understanding the riskiness of the investment, but is imperative to this analysis because volatility of each asset class is reduced by its tax burden. Consider that when an investment realizes a gain, the investor pays a tax on that gain, reducing the net return. Conversely, when an investment realizes a loss, the investor can use that loss to offset other tax liabilities, increasing the net return. As the
Effect of taxation is incurred over time, the highs are not as high and lows not as low as they would be on a pre-tax basis. Therefore, volatility of the investment is reduced.

In a post-tax environment, each asset class effectively experiences a slightly reduced level of volatility than it would in a pre-tax environment. In practice this allows us to allocate a higher percentage of the portfolio to riskier asset classes in a taxable account than in a tax-exempt account, while maintaining a similar risk profile.

We employ optimization software that permits us to achieve superior portfolio allocations on both a pre-tax and post-tax basis. The optimization process incorporates our asset class risk and return assumptions we developed through our proprietary model, as well as relevant information about tax effects we determined through parsing the return assumptions discussed above.

In this process we identify a mix of assets that offers the highest estimated return for a given risk target and the highest tax efficiency. This stage of the process focuses on traditional asset classes of cash and equivalents, taxable and tax-exempt bonds, U.S. large/mid-cap equities, U.S. small/micro-cap equities, international equities, emerging markets equities, global REITs, and natural resources; and when appropriate we add alternative asset classes at a later step. Through this exercise we arrive at our portfolio mixes, each based on a particular risk tolerance level. Our risk profiles are titled as follows: All Fixed Income, Risk-Averse, Conservative, Moderate, Aggressive and All Equity.

For each risk profile, we identify a risk target that best matches with the level of volatility and maximum loss tolerable to clients in that range. Our LNWM client service advisors operate with a number of tools that aid clients in identifying their appropriate risk tolerance.
For each risk profile, we hold target volatility constant and optimize portfolio allocations on a pre-tax and post-tax basis. In other words, the Conservative risk profile maintains a target volatility of 8.3% regardless of whether the account is taxable or tax-exempt, but will have a slightly different asset allocation because of the tax effect.

We construct portfolio mixes within these same risk profiles to include alternative investments as well. Since we do not believe that alternative investing is appropriate for every client, we derive an additional set of portfolio mixes for this purpose. For clients for whom alternative investments are suitable, we begin with the current traditional portfolio mix corresponding to each risk profile and then re-optimize to include allocations to hedge funds, private equity, private real estate, and natural resources. We optimize portfolios with alternatives on a pre-tax and post-tax basis, and maintain a consistent volatility target for each risk profile between taxable and tax-exempt accounts.

Since strategic allocations are intended to span a multi-year investment horizon, strategic targets are not expected to change frequently. We re-evaluate all of our assumptions and portfolio mixes on at least a semi-annual basis, or when significant and likely permanent shifts in capital markets occur. When opportunities arise through temporary dislocations in the capital markets to either protect our clients from loss or to improve expected returns, we may implement tactical positions.

TACTICAL ASSET ALLOCATION

SEIZING SHORT-TERM OPPORTUNITIES TO ADD VALUE

While LNWM typically approaches asset allocation decisions with an investment horizon of multiple years, our longer-term focus doesn’t mean that we employ a simple “buy and hold” strategy. We understand that there are periods of market dislocation that present both opportunities as well as challenges – neither of which should be ignored. We take advantage of these situations through tactical or shorter-term (typically less than 2-years) allocation strategies.

These tactical strategy positions are properly sized to take advantage of large discrepancies in the markets while not overpowering our clients’ strategic allocations. Rather than engaging in rapid and aggressive market timing, we seek to improve
our clients’ potential for returns with tighter management of investment risks through infrequent tactical positions, intended to augment our longer-term strategic allocations.

We base our tactical allocation decisions on thorough analysis of economic data and capital markets fundamentals. We constantly survey a multitude of economic indicators and incorporate them into our proprietary models to help us gauge the market cycles and the health of particular asset classes or sectors. We review capital market indicators like interest rates, currency exchange rates and earnings growth rates for significant deviations from normal behavior. We also monitor the relative valuation of an asset class or sectors against both historical averages and relative to other asset classes or sectors. Additionally, we evaluate a number of momentum indicators and look at fund flows. To reiterate, before a tactical allocation is made, the thesis around it has been thoroughly researched.

Once a potential tactical position has been indentified, we then analyze the probability of loss and volume of capital at risk. We seek not only opportunities for our clients to earn a superior portfolio return, but also situations where we can mitigate substantial risks. We make a tactical decision only when our analysis concludes that benefits in the form of improved return potential or stronger risk mitigation outweigh the costs of implementation and provides a high probability of success. Often these allocations are simply overweight or underweight positions within the strategic target rebalancing thresholds. Entry and exit points to these strategies are determined at the time of initial proposals.

Any changes to our strategic or tactical asset allocation framework must be approved through a majority vote of the Investment Strategy Committee. Members of the committee include LNWM’s Chief Executive Officer and President, Chief Investment Officer, General Counsel, Chief Compliance Officer, Managing Director of Fiduciary Services, Client Service Team Leads, and Investment Strategist. The firm’s management, legal, investment and client servicing teams are all represented in the decision-making process.

The foundational, strategic allocation combined with the agility of the tactical overlay allows us to keep a long-term view of investing without giving up the opportunity for important return generation or risk protection in the short-term.
ABOUT LAIRD NORTON WEALTH MANAGEMENT

With nearly $4 billion in assets under advisement, Laird Norton Wealth Management is the Northwest's premier wealth management company. Originally founded to serve the financial management needs of the Laird and Norton families in 1967, the firm now provides personalized wealth management solutions for more than 425 individuals, families, business leaders, private foundations and nonprofit organizations. For nearly half a century, Laird Norton Wealth Management has been driven by a passionate commitment to help its clients and their families achieve security, find happiness and thrive in every aspect of their lives. The company is relentless in the pursuit of client satisfaction and is committed to never fail at putting a client’s best interest as the number one priority.

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