Beyond Total Market Indexes

Improving on Simply "Buying the Market"

The rising popularity of indexing and low cost investing in recent years has been of great benefit to investors. Individuals and institutions can now access a low cost, diversified, multi-asset class portfolio similar to even the largest institutional investors. However, focusing exclusively on costs should not result in neglect of the most important decision that investors face: the asset allocation decision.

Declining costs are a benefit for investors, but a well-designed asset allocation strategy can have a much more significant impact on portfolio growth than whether a fund or manager is available that can save them a few hundredths of a percent in fees each year. A thoughtfully designed mix of asset classes in a portfolio can result in improved diversification and greater return potential compared to a traditional stock market index portfolio and can still be implemented in a low cost manner.

Additional Asset Classes

Alesco Advisors' portfolios often include investments in asset classes that are not typically included in a simple "total market" index approach. For example, micro cap stocks (represented in Chart 1) have a long track record of generating significant excess returns and are not meaningfully represented in an index like the Russell 3000 Index or the CRSP US Total Market Index.

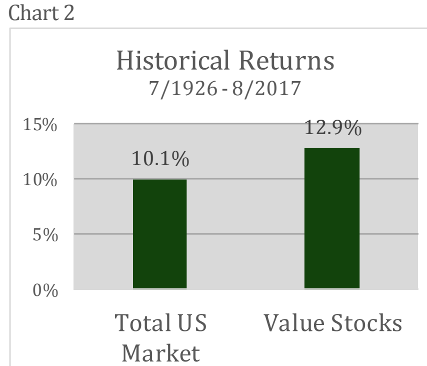
Chart 1

Other asset classes, such as Treasury Inflation-Protected Securities (TIPS), floating rate bonds, bank loans, and commodity futures can serve important roles in portfolios by improving expected returns, reducing risk, and/or providing diversification from traditional stock and bond investments. However, none of these asset classes are included in typical total market indexes.

Factor-Based Strategies

Alesco portfolios also incorporate factor-based strategies. These strategies overweight investments with characteristics that have theoretical and empirical evidence of providing higher returns over extended time periods. One example of how we seek to capture a factor premium is through an allocation to value stocks. For long-term investors, overweighting value stocks in a portfolio has produced higher returns than simply investing in a total market index (see Chart 2).

Chart 2

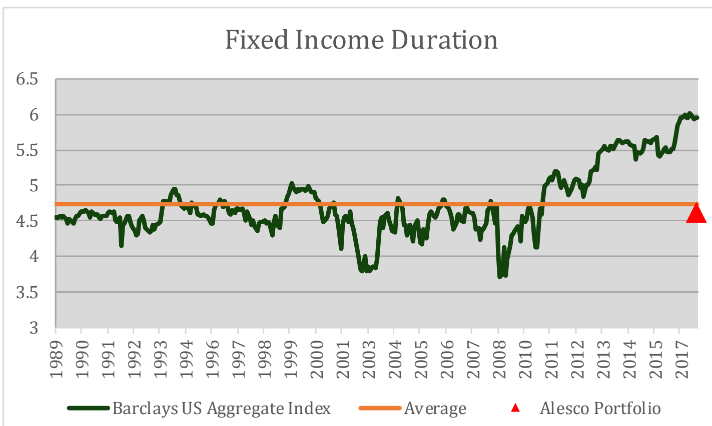


Other factor-based premiums are also included in Alesco portfolios, such as small cap, profitability, and credit premiums.

Tactical Allocation Changes

In most cases investors are best served by an investment strategy that is focused on maintaining long-term allocations to multiple asset classes. However, there are times when capital markets provide unusual opportunities or unusual risks. In those times, the ability to make modest adjustments to a portfolio's asset mix can produce benefits. In late 2016, Alesco Advisors increased allocations to international equities in response to valuation measurements that were significantly more attractive than those in the United States. In the fixed income portion of our portfolios, we have maintained an average duration near the market's historical average, even as the duration of the bond market has increased. The high duration of the bond market reflects an abnormally high level of interest rate risk (see Chart 3).

Chart 3



The flexibility to respond to unusual market conditions is often missing in a static, total market index approach, resulting in potential missed opportunities and providing a manager with one less tool available to manage risk.

Contact Us

If you have questions or comments, or would like additional information regarding our services, please contact us:

Headquarters
Tobey Village Office Park
120 Office Park Way
Pittsford, NY 14534
Phone: (585) 586-0970
Toll Free: (800) 277-3440
info@alescoadvisors.com

Buffalo
120 West Tupper Street
Buffalo, NY 14201

Holly Mergenhagen:
Office: (716) 768-1494

San Francisco
One Market Street
Spear Tower, 36th floor
San Francisco, CA 94105

Katharine Earhart:
Cell: (415) 309-5497
Office: (415) 293-7790

Maya Lis Tussing:
Cell: (415) 999-4344
Office: (415) 293-7791

Visit us on the web at
www.alescoadvisors.com

Past performance is not indicative of future returns. Total US Market = Fama/French Total US Market Index. Smallest 10% of Stocks = CRSP Decile 10 Index. Value Stocks = Fama/French US Value Research Index. All returns are annualized. Return data from Dimensional Fund Advisors. Historical duration for Barclays US Aggregate Index from Bloomberg. Data for duration for Alesco Fixed Income Portfolio from Morningstar Direct. Calculations by Alesco Advisors.

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