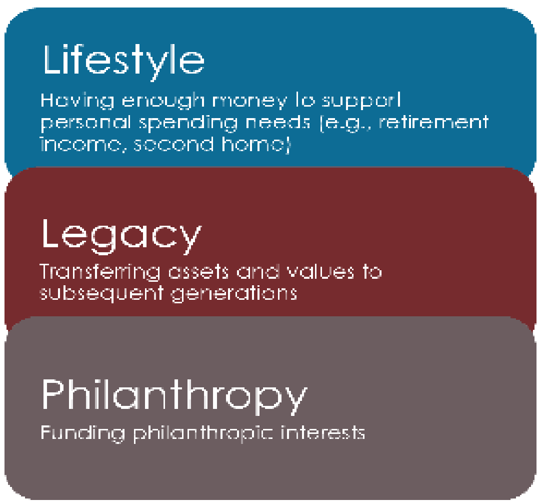
Mirror, Mirror, on the Wall…
Designing Portfolios that Reflect Individual Preferences

As the story goes, the mirror never lies.

Before we think about portfolio-building specifics, we engage with each client to gather as much information as possible to get a true image of the client's lifestyle and wealth goals — what we refer to as the "assessment phase." Based on information clients share with us, we strive to construct portfolios aligned with their goals and objectives.

There are many elements in the assessment phase but, at a high level, it enables us to build a balance sheet (i.e., assets, liabilities and net worth) using the client's information. We view the balance sheet as the "source of funds" for the client's wealth objectives of lifestyle, legacy and philanthropy. Each wealth objective can be thought of as a distinct pool of capital:



Portfolios with distinct characteristics

Each of the above-referenced pools of capital has unique characteristics that shape how they are invested and could influence the outcome of those investments. Some of the more common characteristics we consider when shaping pools of capital into customized portfolios include:

- Investment time horizon
- Liquidity needs
- Minimum levels of income
- Required return
- Tax status
- Volatility tolerance

By disaggregating the wealth objectives into distinct pools of capital, we can prescribe an investment policy that best meets the needs of each portfolio owner. Under this framework, unique portfolios are constructed to seek each objective, and we spend a significant amount of time setting expectations for portfolio behavior and investment outcomes over different investment horizons.

Deriving the policy portfolio

Portfolio outcomes are influenced by a number of variables, some known and controllable, others unknown and uncontrollable. We cannot forecast market behavior and psychology and their impact on asset prices, but we can estimate returns, volatility and correlations over long-term investment horizons. By combining this information with the desired portfolio characteristics and client preferences, we have the raw material to consider an appropriate investment policy. Below we describe a set of optimal portfolios that have varying degrees of expected return and volatility along the risk spectrums.

Low Risk	Moderately Low Risk	Moderate Risk	Moderately High Risk	High Risk

Lower Risk ⟵ ⟶ Higher Risk

ASSET ALLOCATION MODEL - ALL ASSET

Asset Class	Income w/ Mod. Growth	Balanced	Growth w/ Income	Growth w/ Mod. Income	Growth
			WEIGHTS		
Cash Reserves	5%	5%	5%	5%	5%
Fixed Income	60%	45%	30%	15%	5%
Large Cap Equity	12%	20%	27%	34%	40%
Small Cap Equity	2%	3%	5%	6%	7%
International Equity	6%	10%	14%	17%	20%
Total Equity	20%	33%	45%	57%	67%
Absolute Return	5%	5%	5%	5%	3%
Private Equity	5%	7%	10%	13%	15%
Real Estate	5%	5%	5%	5%	5%
Commodities	0%	0%	0%	0%	0%
Total Alternative	15%	17%	20%	23%	23%
Expected Pre-Tax Return	5.3%	6.1%	6.9%	7.6%	8.0%
*Expected After-Tax Return	4.3%	5.0%	5.5%	6.0%	6.3%
Standard Deviation	6.4%	8.4%	0.6%	12.8%	14.6%

TIME PERIOD	EXPECTED RETURNS: ESTIMATED DOWNSIDE CASE**				
1-Year Period	-7%	-10%	-14%	-18%	-21%
5-Year Period	0%	1%	2%	4%	5%
10-Year Period	1%	1%	0%	0%	-1%

Asset allocation percentages may not add up to 100% due to rounding

**Expected After-Tax Return assumes an investor is subject to the highest marginal tax rates in the U.S. at the time of publication.*

***Expected returns in the "Estimated Downside Case" are intended to illustrate the relative performance of the various models in an adverse market scenario. The term "Estimated Downside Case" refers to Glenmede's estimate of how each portfolio could be expected to perform in periods of heightened volatility (pre-tax). This scenario is derived by observing how equity markets behave in the bottom 2.5% percentile of historical returns and how other financial assets typically perform relative to equities in those periods. The data shown in the table shows expected returns in those environments over one, five and ten-year periods after the onset of the associated market volatility. These are Glenmede's projections, which are based on information available at the time of publication and may change thereafter. Outcomes may differ materially from expectations and projections.*

RISK-RETURN TRADEOFF

This concept follows that the acceptance of additional risk in an investment portfolio should be compensated by higher expected returns. Low levels of uncertainty (low risk) are associated with lower potential returns, whereas high levels of uncertainty (high risk) are associated with higher potential returns. According to the risk-return tradeoff, invested money can render high profits only if it is subject to the possibility of being lost. Because of the risk-return tradeoff, it is necessary to be aware of personal risk tolerance when choosing portfolio investments. Taking on some risk is the price of achieving higher returns. While it is not possible to eliminate risk, it is possible to manage it. The goal is to find an appropriate risk-return tradeoff that can generate long-term positive returns while allowing the investor to feel comfortable with the level of risk taken.

The asset allocation, which is driven by the investment policy, is the largest influence on a portfolio's projected risk and return. Therefore, it is imperative we correctly pair clients with policy asset allocations that fit within the investment policy. We want clients to have the confidence to stick with their portfolio when volatility emerges. Otherwise, there is the risk they could liquidate their portfolio when there is uncertainty and the market declines. If expectations and potential portfolio behavior are well-understood from the outset, we can better help our clients navigate an ever-changing investment landscape.

Disaggregating wealth objectives into multiple portfolios

A common mistake occurs when families view their net worth as a singular pool of capital. This could potentially lead to suboptimal outcomes and hinder wealth maximization. For example, a family approached Glenmede looking for advice on this very issue. The family had sufficient wealth to comfortably fund their lifestyle needs, but also wanted to provide for their children's future. In addition, the family desired to make an impact beyond themselves by supporting numerous charitable causes.

The patriarch and matriarch, both in their 60s, initially viewed risk from their own personal perspective, which drove their singular asset allocation (i.e., aggregated approach). They had the ability, but not the willingness, to take more risk to seek a higher return. We worked with the family to designate three distinct pools of capital, each driven by its own unique circumstances (i.e., disaggregated approach):

- Pool A (Lifestyle) was used to fund lifestyle needs with a high "probability of success."
- Pool B (Legacy) was designed to maximize the transfer of wealth to future generations.
- Pool C (Philanthropy) was structured to fund various philanthropic interests.

Pools B and C, and the performance thereof, would not impact lifestyle needs and could be structured to generate more growth than the current asset allocation allowed (i.e., it reflected the patriarch and matriarch's aversion to volatility over shorter-term periods).

The exhibit below displays multi-purpose as well as separate lifestyle, legacy and philanthropy portfolios, and how the aggregated approach differed from the disaggregated approach. In this case, the patriarch and matriarch could structure an investment strategy in accordance with their investment objectives and risk tolerances to comfortably fund their lifestyle needs, while creating the potential for greater long-term wealth for their legacy and philanthropic interests.

Model Portfolio	Expected Return	Expected Volatility	Starting Balance	10-Year Portfolio Value	20-Year Portfolio Value	30-Year Portfolio Value
Multi-Purpose (50 Equity & Alts / 50 Bonds)	5.77%	8.19%	$25,000,000	$45,695,620	$78,216,826	$131,646,990
Lifestyle (50 Equity & Alts / 50 Bonds)	5.77%	8.19%	$10,000,000	$18,557,465	$32,113,267	$54,504,148
Legacy (80 Equity & Alts / 20 Bonds)	7.42%	13.10%	$10,000,000	$21,225,744	$39,901,768	$74,761,250
Philanthropic (65 Equity & Alts / 35 Bonds)	6.60%	10.56%	$5,000,000	$10,176,477	$18,660,170	$33,864,281
Total			**$25,000,000**	**$49,959,686**	**$90,675,205**	**$163,129,679**

Conclusion

This article focused on the foundational components of building portfolios, including asset allocation, portfolio design, risk management, tactical opportunities and the role of rebalancing. We believe clients who do not incorporate these components into the investment process may assume more risk than warranted, which could diminish wealth accumulation over the long term.

We understand there is a cohort of clients who wish to keep their finances as simple as possible. However, our objective is to help families achieve their financial objectives by providing the framework and tools to do so. For clients who can entertain more degrees of complexity, the opportunity set is more robust. At the end of the day, the client has to "live" the portfolio every day, week, month, year and decade, which is why our goal is to construct portfolios investors can stick with — in good times and bad.

Future topics

In subsequent articles, Glenmede's Portfolio Construction Team will discuss how we view the roles of the various asset classes and how they interact within a multi-asset class portfolio. We will also highlight portfolio diversification and its benefits as well as investing along the style spectrum (i.e., value and growth) and the types of strategies used in building a well-constructed portfolio.