

Is Your Portfolio as Efficient as It Could Be?

When you look at a line chart of an investment's historical performance, one feature to note is its volatility – how frequent and how extreme the ups and downs have been. This is significant because volatility is the most commonly used measurement of an investment's risk. The greater the volatility, the riskier the investment is considered to be.

If you viewed a chart comparing the stock market's vs. the bond market's performance, you'd see stocks have been significantly more volatile than bonds. Logically then, a 100% bond portfolio should be less risky than one including both bonds and stocks. Right? Not so fast.

In fact, according to a Morningstar study for the years 1970 through 2015, a portfolio comprising 67% bonds (measured by the 20-year U.S. government bond) and 33% stocks (using the Ibbotson Large Company Stock Index) offered less risk **and** better returns than a 100% bond portfolio. In other words, the former was more “efficient” than the latter, which leads to a concept investors should be aware of: the efficient frontier.

Start with the basics

Having a grasp of the efficient frontier begins with understanding:

- The relationship between risk and return
- How diversification can help manage risk and return

In general, risk and return go hand-in-hand. As an investment's risk increases, so should its return. If you buy a Treasury bond, the return will probably be low because the risk of default is minimal. If you buy a stock, however, the potential risk is significant – think back to what happened to stocks during the Great Recession – and you should expect a greater return potential as “compensation” from the market for accepting that additional risk. (A high risk/low return investment is probably not a good idea.)

Diversification is simply blending different investments in a portfolio in an effort to manage risk and return. The result is your “asset allocation.” A very simple asset allocation might include stocks, which tend to be risky but offer growth potential, and bonds, which have been more stable and provide income (interest). You can help manage your risk and return by how much you allocate to each type of investment. For example, if you have a 75% stock/25% bond portfolio, it should offer a greater risk and return potential than one that's 25% stocks/75% bonds.

Getting to an efficient frontier

Of course, there are lots of other investments for you to choose from, and there are an infinite number of portfolios you could construct from the stocks, bonds, and other assets available. Each of these blends has a unique overall risk and return level. If you plotted them all on a chart, you'd likely see what's shown in the hypothetical graph below. The “pies” – representing different asset allocations – farthest to the left and highest up are the ones with the best expected risk/return tradeoffs. If you connected those “dots,” you would have it: the efficient frontier.

Connecting the Dots to Determine an Efficient Frontier

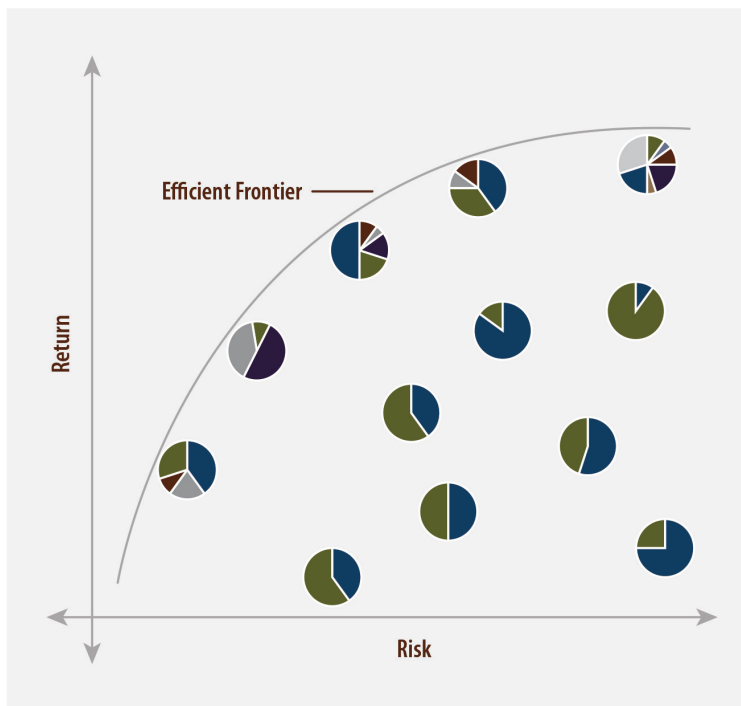


Chart is conceptual and does not reflect any actual returns or represent any specific asset classifications.

That's what the efficient frontier is, but what does it mean for investors?

It means that if your risk/return tradeoff doesn't land along the frontier, your portfolio is not as efficient as it could be. You're taking on too much risk for the level of return you're getting, and you probably need to make adjustments to decrease risk, improve return, or both.

Finding help

Determining whether your portfolio is as efficient as it could be may require help from a professional Financial Advisor. He or she will likely ask about your goals (what you're investing for), time horizon (how long until you need to tap into your investments), and risk tolerance (how comfortable you are with swings in your portfolio's value). Based on your responses, your advisor can help build a portfolio designed to help reach your goals as efficiently as possible.

Asset allocation cannot eliminate the risk of fluctuating prices and uncertain returns.

This article was written by/for Wells Fargo Advisors and provided courtesy of David M. Gustin, AAMS®, Vice President-Investments in Melville, N.Y. at 631-753-4533

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