GUIDE TO PORTFOLIO CONSTRUCTION

The role of strategic asset allocation
Guide to portfolio construction

Market and economic uncertainty, combined with relatively low expected returns for many asset classes, are making it harder for individuals and institutions to reach their financial goals. A thoughtfully designed portfolio that helps you embrace market opportunities while preparing for the unexpected has never been more important.

There are several components of a well-constructed portfolio, including a robust strategic asset allocation that's consistent with your long-term goals and objectives. A mix of asset classes such as equities, fixed income and alternatives, and strategies such as tactical asset allocation, active versus passive investing, and portfolio rebalancing all have a role to play.

This guide highlights how the strategic use of asset allocation can improve portfolio performance and help you achieve your ambitions.

Strategic asset allocation—the foundation of a well-constructed portfolio

Strategic asset allocation is based on the idea that broad diversification improves a portfolio’s risk/return profile—in other words, if you diversify you aim to take less risk and still achieve your targeted return. Each portfolio combination of stocks, bonds and cash provides different expected performance outcomes. By examining the correlation of returns between these asset classes, you can construct a portfolio that maximizes your returns while respecting your objectives and constraints.

At CIBC Asset Management (CAM), we follow a consistent, rigorous strategic asset allocation process to optimize investor portfolios. This relies on the ABCs of investing: allocation, broad diversification and correlation.

Explore our six-step strategic asset allocation process:

1. Determine investment objectives and profile
2. Forecast long-term returns for different asset classes
3. Model and calculate optimal asset allocation
4. Select managers
5. Examine risk exposure and estimate drawdowns during crises
6. Monitor regularly and rebalance when necessary
Step 1: Determine investment objectives and portfolio profile

To determine your investment objectives and the portfolio profile that best matches those objectives, here are some factors you’ll need to consider:

- **Financial goals**
- **Time horizon**
- **Income needs**
- **Liquidity needs**
- **Tax considerations**
- **Unique circumstances**

- **Risk tolerance**

We’ve identified and grouped investor profiles into broad types that range from the **most conservative** (investors with the lowest risk tolerance) to the **most aggressive** (investors with the highest risk tolerance). From this, we’ve defined five general portfolio types: Conservative, Balanced Income Oriented, Balanced Income and Growth, Growth and Aggressive Growth.

**Investor profile and historical performance (1950-2019)**

<table>
<thead>
<tr>
<th>Portfolio type</th>
<th>Historical annualized return (%)</th>
<th>Volatility2 (%)</th>
<th>Best 5-year annualized return (%)</th>
<th>Worst 5-year annualized return (%)</th>
<th>Income needs (liquidity)</th>
<th>Recommended time horizon</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conservative: Suitable if you have immediate income requirements and require portfolio returns sufficient to preserve capital during the investment cycle.</td>
<td>7.2</td>
<td>4.1</td>
<td>19.1</td>
<td>2.7</td>
<td>Very high</td>
<td>1-3 years</td>
</tr>
<tr>
<td>Balanced Income Oriented: Suitable if you have occasional income needs and are willing to take moderate risk to achieve those income requirements and preserve capital.</td>
<td>8.2</td>
<td>5.6</td>
<td>21.7</td>
<td>1.7</td>
<td>High</td>
<td>3-5 years</td>
</tr>
<tr>
<td>Balanced Income and Growth Oriented: Suitable if you have a longer-term investment horizon and can tolerate some volatility to achieve capital preservation and principal growth.</td>
<td>9.1</td>
<td>7.5</td>
<td>25.3</td>
<td>0.1</td>
<td>Moderate</td>
<td>5-7 years</td>
</tr>
<tr>
<td>Growth: Suitable if you are a longer-term investor focused on growing your capital and are comfortable with short-term market downside volatility.</td>
<td>9.8</td>
<td>9.0</td>
<td>28.5</td>
<td>-1.4</td>
<td>Low</td>
<td>7-10 years</td>
</tr>
<tr>
<td>Aggressive Growth: Suitable if you are a longer-term investor focused on growing your capital and are very comfortable with short-term market downside volatility.</td>
<td>10.7</td>
<td>11.3</td>
<td>32.6</td>
<td>-3.3</td>
<td>Very low</td>
<td>&gt; 10 years</td>
</tr>
</tbody>
</table>

Source: CIBC Asset Management, June 2020

1 Following recent market volatility, many investors are paying much more attention to their personal risk tolerance. In general, decisions about how much risk is acceptable for you should be focused on longer and more normalized periods that coincide with your time horizon. This decision should be less focused on shorter periods of performance and volatility, unless your time horizon is also short.

2 As measured by historical annualized standard deviation.
Step 2: Forecast long-term returns for various asset classes

It’s important to try and understand what returns various asset classes could provide over the long term (10 years or more). At CAM, we forecast the expected return and volatility for each asset class (fixed income, equities, cash) with a calculation that uses three main inputs:

- **Current income**: For fixed income, this is the coupon yield and for equity, this is the dividend yield.
- **Growth in income**: This is earnings growth, and only applies for equity.
- **Change in value**: The impact of changing interest rates (for fixed income), or cyclically-adjusted price-to-earnings (P/E) ratios that converge towards their long-term equilibrium value (for equity).

\[
\text{RETURN} = \text{CURRENT INCOME} + \text{GROWTH IN INCOME} + \text{CHANGE IN VALUE}
\]

The return parameters are key components in building an appropriate asset allocation recommendation. The expected returns for each profile reflect both the forecasted returns for each asset class as well as the proposed allocations to each asset class (see Step 3).

The forecasted returns and volatility are calculated for each asset class and combined to create model portfolios for each investor profile. The graph below illustrates the expected return and volatility by portfolio type.

**Expected long-term returns and volatilities by portfolio type**

Source: CIBC Asset Management, June 2020
Step 3: Model an appropriate asset allocation

The goal of this step is to select the mix of asset classes that best meets your investment objectives.

CAM calculates the expected long-term returns and the risk (i.e. volatility\(^3\)) for all possible portfolio combinations. Each investor profile is then assigned the asset mix with the highest return for the level of risk selected.

Sample asset allocations for various investor risk profiles

Source: CIBC Asset Management, June 2020

\(^3\)Risk, as measured by standard deviation.
Step 4: Manager selection

In this step, we identify investment managers/strategies within each asset class that we believe have the greatest ability to meet or exceed the forecasted asset class returns—our “highest conviction” managers. Manager selection considers the manager’s style and degree of differentiation (i.e., active risk) versus their benchmark. Using our manager research process and the most up-to-date investment views, we look to ensure that our clients are being rewarded appropriately when the manager takes additional risk.

Here are a few examples of equity strategies that can be included in various allocations to help meet investor goals.

<table>
<thead>
<tr>
<th>Goal</th>
<th>Manager strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low Volatility</td>
<td>Strategies focused on helping investors preserve capital during volatile markets by focusing on less volatile, higher-quality business models.</td>
</tr>
<tr>
<td>High Dividend Yield</td>
<td>Strategies focused on providing income by investing in stocks with above-average dividend yields.</td>
</tr>
<tr>
<td>Growth</td>
<td>Strategies focused on principal appreciation that can invest in companies with above-average growth potential. These strategies can take advantage of disruptive technologies and consumer trends globally. This could include an allocation to smaller-cap companies, which typically have greater growth potential versus larger-cap, more mature companies.</td>
</tr>
<tr>
<td>Value</td>
<td>Strategies focused on investing in companies with cheaper valuation multiples. This group of stocks has been out-of-favour for most of the past decade and might provide an opportunity to profit from a “stylistic” trend reversal.</td>
</tr>
</tbody>
</table>
Step 5: Examine exposure to various risks. Estimate drawdowns during crises.

In this step, we examine how much a portfolio is exposed to a number of risk factors including economic growth, interest rates, inflation and currency.

The risk composition of the five investor profiles is illustrated below. For the conservative profile, no particular risk dominates, highlighting its low risk concentration. As we move to higher risk portfolios, their relative performance depends more on economic growth (and therefore global equity performance), while other risks are relatively less significant. Where appropriate, equity risk can be reduced by including alternative and emerging asset classes with distinct risk and return characteristics.

Breaking down a portfolio’s expected performance into its main risk factors is a sophisticated risk management tool. It allows us to tweak the portfolio where necessary and ensure that the level of risk is appropriate for each investor group.

![Portfolio exposure to macroeconomic factors](image)

Source: CIBC Asset Management, June 2020

As part of this step we also estimate the historical portfolio capital drawdowns of the various portfolios. We’re looking to answer the question: Are these drawdowns consistent with the risk tolerance of each investor group?

Step 6: Monitor regularly. Rebalance when necessary.

The last step is to monitor and periodically rebalance the strategic mix of assets in each investor profile portfolio. CAM has established a Multi-Asset Solution committee that oversees the asset allocation process. The committee’s ongoing monitoring ensures that the portfolio continues to reflect the main insights and leading edge research developed within CAM. Investors are also encouraged to regularly revisit their financial objectives and strategic asset allocation in consultation with their advisor.
Key strategic asset allocation considerations:

- Strategic asset allocation is the fundamental building block to help meet long-term investment objectives.
- Broad diversification among major asset classes can increase portfolio efficiency.
- The best strategic asset mix for each investor profile is determined by understanding the investor’s goals and objectives, examining the correlation between various asset classes and diversifying with these factors in mind.

Let’s partner on your portfolio construction

Changing market conditions don’t change your goals, whether it’s saving for a home, a child’s education or investing for retirement. Careful portfolio construction that helps you embrace market opportunities while preparing for the unexpected has never been more important.

Your CIBC advisor can help you develop a targeted investment approach using the multi-asset solutions that work best for you.

Contact us today to tailor your portfolio and help you get where you want to be.

To learn more, contact your CIBC advisor.

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