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# Asset Allocation in Uncertain Times

**BOTTOM LINE: Using a dynamic approach to asset allocation can help "weatherproof" your portfolio in times of uncertainty.**


## Summary

A proper asset allocation plan provides a long-term framework to structure a portfolio. Yet, in some environments value can be added by taking a more active approach to portfolio construction. In the face of today's economic uncertainties, Baird's expectation for stock market returns is somewhat muted. Therefore, we believe that a dynamic asset allocation plan could benefit many clients.

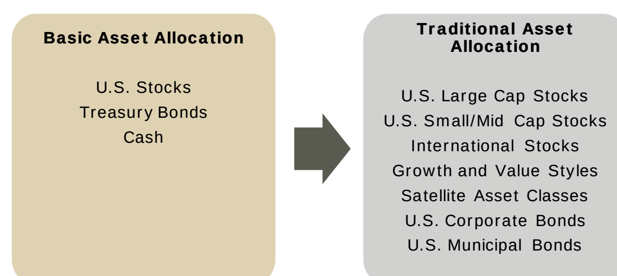
A dynamic asset allocation, as opposed to a static asset allocation plan, further broadens the investment universe to include options that seek to capitalize on market opportunities, avoid major pitfalls, or reduce portfolio volatility. We consider there to be three major components of a dynamic asset allocation plan: traditional asset allocation, alternative diversification, and flexible strategies.

This adaptive approach reflects the evolving opportunity set in the marketplace and also recognizes the changing conditions that our clients are facing.


**Dynamic Asset Allocation Plan**

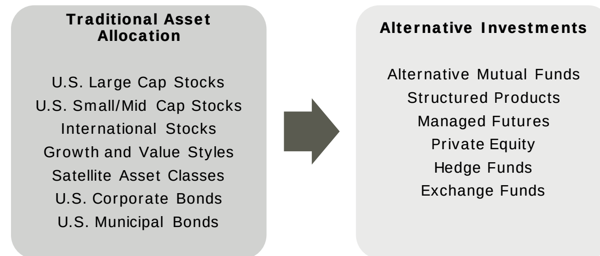

## The Foundation: Traditional Asset Allocation (60-100% of assets)

A long-term asset allocation plan based on a client's risk tolerance and required return remains the foundation of any portfolio. Baird's Investment Policy Committee has developed a series of model portfolio allocations using time-tested asset classes structured with the goals of increased diversification and reduced volatility beyond that of a basic asset allocation plan. This includes stock investments that vary in terms of size, style and country, or bonds of both corporate and municipal issuers.




However, many traditional asset classes are not providing the diversification benefits that were expected. As a result, Baird incorporates satellite asset classes (defined as high yield bonds, real estate, commodities and emerging markets) into our asset allocation models. These are traditional, yet underutilized areas that still provide good diversification potential. Furthermore, non-traditional or "alternative" investments options can also be used to round out a portfolio. Broadly, these investments are those with a higher expected risk/return trade-off or are uncorrelated with other classes and therefore provide additional diversification.

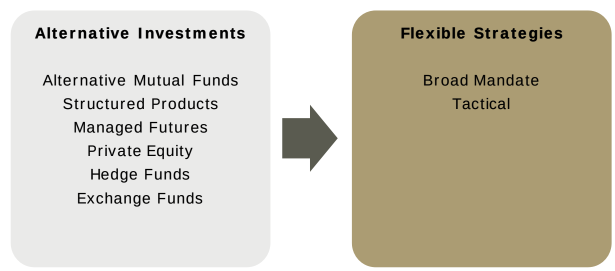
### The Diversifier: Alternative Investments (0-20% of assets)




The major benefit of alternative investments is the low correlation between these classes and other more traditional asset classes. Lower correlation, or the degree to which two investments perform similarly, can lead to lower overall portfolio volatility. Stated differently, the performance of these options is not as dependent on the broad stock and bond markets.

We use the term alternative investments in a very broad sense, namely to include any non-traditional asset classes. More commonly this encompasses niche asset classes and absolute return strategies, and may expand to hedge fund and private equity allocations for qualified clients. The goal of combining traditional and alternative methods is to construct a portfolio that has a more favorable risk/reward trade-off and is less susceptible to broad market movements. Note, many alternative investments have unique risks that make them not suitable for all investors (see page 3 for more information).

### The Enhancer: Flexible Strategies (0-20% of assets)




During periods where market returns are uneven and the outlook is uncertain, opportunities exist in a broad range of areas. Capitalizing on these opportunities requires recognizing shorter-term trends in the marketplace, which often oscillate between investment types. Therefore, clients may benefit from employing investment options that have a flexible approach. Broad mandate, or go-anywhere strategies, are not constrained by a specific classification and can invest nearly anywhere. Similarly, tactical managers can invest anywhere but typically focus their investments in a narrower manner.

The main objective of a flexible strategy is to combine investment options that serve a specific role with complementary ones that can play any role in a portfolio. It is important to note that trying to time the market is incredibly difficult. The approaches that we prefer are those that are exploiting short- to intermediate-term trends or undervalued areas, not those that trade rapidly and regularly shift from one area to another. Some additional risk exists with flexible strategies due to a greater reliance on the investment manager than a defined asset class. Consequently, these options may not be suitable for all client types.

### Putting it All Together

Using a dynamic approach to asset allocation can help "weatherproof" your portfolio to handle the volatility and uncertainty evident in the current market. As the investment universe continues to expand in these non-traditional areas we are dedicated to providing more guidance and options for our clients. Baird currently provides due diligence research on over 140 investment options and our Financial Advisors have access to thousands more. Among these available investment options are those that fit into the traditional, alternative and flexible strategies. Maintaining a proper asset allocation plan is a critical key to long-term success.

**Please see Important Disclosures on page 3. For more information please contact your Financial Advisor.**

## Risks of Alternative Investments

There are several risks associated with alternative investments above and beyond the typical risks associated with traditional investments.

- **Higher fees.** Alternative investments can have higher fees. For example, fees can include an annual management fee (1–2%) and an additional incentive fee (10–20%). Fund of funds may also charge yet another management fee. While higher than traditional investments, these fees may or may not be justified when comparing returns net of fees.
- **More complicated.** Alternative managers may invest in a wide variety of investments, including derivatives, and utilize short selling. Understanding complicated investment strategies requires more upfront and ongoing due diligence.
- **Less transparent.** There can be limited transparency into the underlying holdings of these investments. Additionally, many manager evaluation tools are not as well suited for alternative investments, making a manager's investment ability more difficult to assess. Also, some alternative investments are largely unregulated.
- **Less liquid.** Limited partnerships may hold illiquid investments and as such restrict an investor's ability to redeem money. For example, managed futures only offer monthly liquidity, many funds of hedge funds do not allow redemptions in the first year and only annual or quarterly thereafter, and private equity may not allow redemptions for seven or more years. The underlying investments used in an alternative investment strategy may also be exposed to a significant lack of liquidity in stressful trading environments.
- **Less tax-friendly.** Most alternative investment strategies have little to no focus on minimizing taxes. Also, those whose legal structure is a partnership issue a K-1 statement rather than a 1099.
- **May disappoint in strong up markets.** Investments that seek to generate an absolute return often use short selling strategies, and as such tend to lag long only strategies in strong up markets, which may discourage some investors.
- **May not diversify risk in extreme down markets.** In periods of dislocation, the correlations of many types of investments, including alternatives, may increase significantly, as was the case in the extreme down market of 2008.
- **Credit risk.** For some structured products, notes in particular, principal protection guarantees are limited to the credit worthiness of the issuer.

## Important Disclosures

**Past performance does not guarantee future results. Diversification does not ensure against loss. Indices are unmanaged and not available for direct investment.**

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