THE RIGHT END OF THE TELESCOPE
Investment Advice that Meets Objectives
INTRODUCTION

At first blush, with so much financial data all around us, you'd think that finding and implementing good financial advice wouldn't be difficult. Paradoxically, though, more data can lead to poorer financial decisions.

Indeed, investors focused on performance versus indexes and/or performance versus peers are looking through the wrong end of a telescope. They're minimizing instead of magnifying the significance of what affects them the most: progress toward meeting their financial goals.

Nonetheless, we've noticed that most investors concentrate on relative performance. To get a rough measure of this bias, we checked Google Trends, which gave the term "stock index" a score of 36, "top funds" a 14, and "financial goals" just a 3. The left side of Display 1 presents these results in their corresponding font sizes, from banner headline to nearly illegible fine print.

We think that these priorities are backward. For us, defining and achieving financial goals—though it’s no easy task—should be the most important metric by far, as illustrated on the right side of Display 1. That’s because meeting financial goals (both quantifiable and intangible) is what affects investors’ lives. The process empowers investors and leads to better decisions.

Of course, if managers perform well versus indexes and peers, so much the better. As one of the world’s leading investment-management firms, Bernstein has a long history of delivering results to clients. But beating benchmarks will get you where you want to go only if you’re taking the right road.

Why do so many investors have it wrong? Comparisons with indexes and manager peers are widely available and easy to make; there’s a seductive sense of security in the “hard numbers” behind relative performance and peer rankings; and it’s what (almost) everyone else does. But in investing, following the crowd can be a bad move. (See our research paper “The Case for Integrated Wealth Management.”)

DISPLAY 1: INVESTMENT ADVICE: DISTORTED FOCUS

<table>
<thead>
<tr>
<th>What Investors Measure</th>
<th>≠</th>
<th>What Affects Investors’ Outcomes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Performance vs. Indexes</td>
<td>• Meeting Financial Goals</td>
<td></td>
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<tr>
<td>• Rank vs. Peers</td>
<td>• Performance vs. Indexes and Rank vs. Peers</td>
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</tbody>
</table>

Source: Google and AB
THE SIREN SONG OF PERFORMANCE-CHASING

The problem, stated in the timeless prose of compliance officers, is that “Past performance is not necessarily indicative of future results.” Or, as poet Robert Frost more evocatively wrote, “Nothing gold can stay.” Either way, the fact is that “hot” asset classes and investment managers tend to cool off. So chasing the best-performing asset or manager often destroys wealth rather than building it. Nonetheless, it’s what investors too often do.

Consider Display 2, which, on the left side, shows that over the 12 months ending August 2015, US mutual-fund asset flows have all gone into funds rated “five stars” by fund-evaluator Morningstar, and came out of funds with fewer stars. But those star ratings, by definition, are backward-looking. As one academic study showed, within just four years, 86% of five-star investment managers went on to lose their top ratings: They were either downgraded to a lower rating, or they shut down completely (Display 2, right side).

So the evidence strongly suggests that focusing on manager near-term history is very unlikely to produce superior future performance. (Asset-class winners and losers change places as well, in unpredictable patterns, so trying to keep up with the “best” asset is similarly counterproductive.)

One response to the problem with choosing “top-performing” managers is to invest only in passive portfolios such as index funds and exchange-traded funds. Passive investments do provide low-cost exposure to a given asset class. However, we think that index returns in most assets will be relatively modest in the years ahead. Furthermore, we have been expecting market volatility to rise, which is happening as of this writing.

**DISPLAY 2: “HOT” INVESTMENT MANAGERS OFTEN GO COLD**

<table>
<thead>
<tr>
<th>Net Money Flows for US Mutual Funds 12 Months Ending August 31, 2015*</th>
<th>Retention Rate of Highest Fund Rating† Four-Year Period‡</th>
</tr>
</thead>
<tbody>
<tr>
<td>US$ Billions</td>
<td>5 Stars Retained</td>
</tr>
<tr>
<td>5-STAR FUNDS</td>
<td>14%</td>
</tr>
<tr>
<td>$179</td>
<td>79%</td>
</tr>
<tr>
<td>1-, 2-, 3-, and 4-STAR FUNDS</td>
<td>Funds Closed</td>
</tr>
<tr>
<td>$(388)</td>
<td>7%</td>
</tr>
</tbody>
</table>

Past performance is not necessarily indicative of future results.

*Includes net flows to all open-end, actively managed, rated mutual funds, excluding money-market funds and including funds of funds. Flows are at the total-portfolio level, and rating is for the primary share class as defined by Strategic Insight mutual-fund research and consulting.
†Globally offered mutual funds
‡2005–2008
In a lower-return, higher-risk market, we believe that active managers will have more scope to add value. If we’re right, active returns and risk management will become more important (see Bernstein’s January 2015 letter, titled “Greed, Fear, and the Creation of Opportunity,” and our 2015 second-quarter review). And even passive investors need to make a key active decision: when and how to take risk.

**GETTING THE BIG THINGS RIGHT**

When you look at risk, what really matters becomes clear. Display 3 shows the range of rolling one-year index returns for various traditional asset classes over the last 25 years in blue, and the range of relative returns earned by active managers in each asset class in green. Each bar spans returns from the top to the bottom decile of 12-month performance; the diamond represents the median result. As you’ll note, the range of annual index returns for each asset class is far greater than the range of manager returns relative to the index.

For example, using this methodology, we found that US-stock index returns ranged from (14)% to +30%: a 44-percentage-point spread. By contrast, relative returns earned by active managers of US stocks varied far less: from (8)% to +5%. The range of bond returns was much narrower than stocks’, but for bonds too, as for all the asset classes in the display, index returns were significantly more variable than manager performance.

In other words, results have depended more on market fluctuations (or “beta”) than manager skill (or “alpha”). And so is it irrelevant whether you go with a winning or losing manager? Not at all: Every bit of return helps, and as noted above, we think that manager alpha will be particularly helpful in the coming years. But the impact of manager alpha on your long-term investment results will likely be trumped by the impact of your asset-allocation beta decision.¹

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¹For alternative investments like hedge funds, however, manager skill counts much more than it does for traditional investments—and many hedge-fund strategies seek to minimize market exposure. Illiquid alternatives such as private equity also tend to carry greater manager-specific risk.
GOAL-ORIENTED INVESTING

So how do you assess asset-allocation decisions? As you'd expect, there's no one right answer. Display 4 captures the concept by assessing three plausible combinations of return and risk goals. Investor A sought a return greater than 5% per annum with no peak-to-trough drawdown deeper than 20%; Investor B targeted a return greater than 7% per annum with no drawdown deeper than 30%; and Investor C cared only about achieving a return greater than 7% with no drawdown constraint at all.

The display uses historical data, showing the percentage of rolling 10-year periods since 1976 that these various goals were met. In this broad swath of history, some periods accentuate the positive years, and others the negative. So overall, it should be a representative sample. For simplicity, we'll start with portfolios composed of various mixes of global stocks and municipal bonds. (Later we'll discuss how greater diversification can be achieved and beneficial.)

The allocation with the highest frequency of success depended on the investor's goal. Investor A, with more conservative goals (lower return objective, tighter drawdown limit), was best matched to the most conservative allocation—a 30%/70% stock/bond mix—since aggressive allocations often exceeded the drawdown constraint. For Investor B, the moderate portfolio (60/40) came out ahead. And for the aggressive goals of Investor C, the growth-oriented 80/20 mix had the best odds of success: When risk isn't an issue, stocks are your asset of choice.

The display underscores the importance of matching a portfolio's asset allocation to its investment objective. The alternative for investors is likely to be frequent disappointment. Note, though, that this illustration covers only simple return and drawdown goals. In reality, selecting the best allocation should also include expectations about cash flows in and out of a portfolio, the investor's tax situation, prevailing market conditions, and a host of other factors.

DISPLAY 4: CHOOSE AN ALLOCATION THAT SUITS YOUR GOAL
Percentage of Periods Where Both Objectives Were Achieved Based on Rolling 10-Year Index Returns, Jan 1976–Jun 2015*

<table>
<thead>
<tr>
<th>A: Return &gt; 5%; No Drawdown &gt; 20%</th>
<th>B: Return &gt; 7%; No Drawdown &gt; 30%</th>
<th>C: Return &gt; 7%; No Drawdown Limitation</th>
</tr>
</thead>
<tbody>
<tr>
<td>30/70</td>
<td>60/40</td>
<td>80/20</td>
</tr>
<tr>
<td>83%</td>
<td>56%</td>
<td>72%</td>
</tr>
<tr>
<td>56%</td>
<td>72%</td>
<td>56%</td>
</tr>
<tr>
<td>72%</td>
<td>56%</td>
<td>74%</td>
</tr>
<tr>
<td>82%</td>
<td>74%</td>
<td>82%</td>
</tr>
</tbody>
</table>

Investor Goals

Past performance is not necessarily indicative of future results.

*Returns and drawdowns are calculated over rolling 10-year periods based on monthly returns. 30/70 allocation is modeled as 30% global equities and 70% bonds, 60/40 as 60% global equities and 40% bonds, 80/20 as 80% global equities and 20% bonds. Global equities are modeled as 70% US equity, 25% developed international, and 5% emerging markets. Bonds are modeled as the Lipper Intermediate Municipal Bond Fund Average. US equity is represented by the S&P 500 Index; developed international by the MSCI EAFE Index; and emerging markets by a Bernstein simulation through 1984, by the International Finance Corporation (IFC) World Bank Global Index from 1985 to 1987 (IFC Index was reconstructed for the period Apr–Dec 1984), and by the MSCI Emerging Markets Index thereafter.

Source: Compustat, IFC, Lipper, MSCI, Standard & Poor’s, and AB
STICK WITH YOUR ALLOCATION

Careful analysis can help investors pre-experience the outcomes they're likely to see with various allocation decisions. But an investment plan will work only if an investor has the emotional fortitude to stick with it—which is easier said than done. It can be difficult to hold on to an allocation, particularly with a more aggressive portfolio, when the markets get tough.

Consider Display 5, which charts the growth of $1 million in three portfolios from January 2005 through June 2015, assuming a withdrawal of $50,000 per year. In one case, the investor maintains a portfolio 80% in global stocks and 20% in bonds. In the second instance, the investor stays in a much more conservative 30/70 portfolio. And in the third, the investor begins with 80/20, but panics after a 30% loss and switches out of stocks and into cash on November 1, 2008. He remains in cash through March 31, 2012, and returns to 80/20 thereafter. How would each of these investors have fared?

With only 30% in stocks, the conservative investor wouldn’t have lost excessively in the stock implosion, but neither would he have picked up much in the roaring bull market that followed. Altogether, after spending $50,000 a year, he would have ended up with $940,000 at midyear 2015—not too bad considering his regular portfolio withdrawals. The steady 80/20 investor would have suffered a wrenching downturn of 46%, but would have still wound up with $1,150,000 at the end of the time period, after her spending outlays.

However, the market-timer who jumped into cash as the market was going south (the dotted orange line in the display) and then came back in again, but somewhat late, would have been left with only $670,000. He’d have underperformed his two counterparts—including the much more conservative 30/70 investor. In fact, he’d have lost close to half the return of the 80/20 investor who stuck with her allocation, and he’d still have suffered a wrenching drawdown of 38%.

DISPLAY 5: MARKET-TIMING STRATEGIES TEND TO DISAPPOINT

Wealth Values: Jan 2005—Jun 2015 (After Withdrawing $50,000 per Year)*

<table>
<thead>
<tr>
<th>US$ Millions</th>
<th>Ending Value</th>
<th>Worst Drawdown</th>
</tr>
</thead>
<tbody>
<tr>
<td>80/20 Allocation Maintained</td>
<td>$1.15</td>
<td>(46)%</td>
</tr>
<tr>
<td>30/70 Allocation</td>
<td>$0.94</td>
<td>(19)%</td>
</tr>
<tr>
<td>Cash Allocation</td>
<td>$0.67</td>
<td>(38)%</td>
</tr>
</tbody>
</table>

Past performance is not necessarily indicative of future results.

*Results for green path assume 30/70 allocation throughout. Results for blue path assume 80/20 allocation throughout. Results for blue-and-orange path assume 80/20 allocation from Jan 1, 2005, through Oct 31, 2008, cash allocation from Nov 1, 2008, through Mar 31, 2012, and 80/20 allocation from Apr 1, 2012, through Jun 30, 2015. All figures are pretax. 30/70 is modeled as 30% global equities and 70% bonds, 80/20 as 80% global equities and 20% bonds, and cash as three-month US Treasury bills. Global equities and bonds are modeled as described in the footnote to Display 4. US equity is represented by the S&P 500 Index, developed international by the MSCI EAFE Index, and emerging markets by the MSCI Emerging Markets Index. Source: Lipper, MSCI, Standard & Poor’s, and AB
Although this is an illustrative case, it’s—unfortunately—what many investors actually did after 2008. Lots of investors who had flocked to global stocks in the years before the bubble burst stampeded out in 2009, 2010, and 2011, to the tune of $309 billion in outflows. It took until 2013—by which time the global stock market had already rallied 55%—for the fund flows to flip back into stocks. In cycle after cycle, most investors sell low and buy high.

By contrast, after the financial meltdown, Bernstein advised clients to stick with their long-term strategic asset allocations, including their exposure to equities. So one measure of the value of good investment advice is the money saved by avoiding big mistakes. The value of that advice can be significant and quantifiable, as this example shows.

Even so, there’s a deeper dimension to good investment advice that goes beyond the numbers. Planning carefully and thoroughly can create greater understanding of investment trade-offs, which leads to better life decisions. These benefits are hard to measure precisely, but nonetheless hugely valuable. We try to illustrate the benefits that comprehensive investment advice can add in the three hypothetical case studies that follow.

CASE STUDY #1: A SUCCESSFUL PROFESSIONAL PLANS FOR HER FUTURE

Carla was 45 years old when she came to see us. A partner at a top consulting firm earning $500,000 in annual salary and averaging another $500,000 in bonus, she was the primary breadwinner for her family.

Carla was proud that she had paid off her student loans and was living off her after-tax salary. This meant she had begun saving about $250,000 annually (the value of her bonus after taxes). So in just a few years she had amassed a $1 million portfolio, which was conservatively invested in a 30/70 stock/bond allocation.

Lots of Questions

While Carla recognized that everything seemed to be going well, she had many questions about her finances and her lifestyle. On the one hand, she was unsure whether she was on track for a secure retirement close to age 65 even if she remained in her current high-pressure job. On the other hand, she also dreamed of moving to a less stressful job at some stage and devoting more time to other activities. She knew that such a move would mean a big pay cut: If she took the plunge, would she still have the ability to retire at a reasonable age without jeopardizing her financial security? Was she saving enough? Expecting too much from the markets? Or relying on too-conservative an asset mix? Although Carla was a highly motivated, successful professional, she did not feel comfortable about her financial future. And her lack of a clear plan made her anxious.

Many Levers

First we reminded Carla that she still had a huge asset in her future earnings power or “human capital” (see “Building and Spending Your Capital,” page 9). And she was growing her financial capital at a good clip. But was it fast enough to meet her objectives? In a word, no—not if she wanted to maintain her spending rate, move to a lower-paying job, and retire not long past age 65.

Using our proprietary Bernstein Wealth Forecasting System™, we estimated that if she changed jobs in 10 years, she’d need to push out her retirement—significantly so. Indeed, if Carla wanted to plan for poor future markets (always a good idea) while maintaining her conservative asset mix and spending
an inflation-adjusted $200,000 in retirement, we estimated that she would need to work past age 75 (Display 6). This was not a prospect that Carla found appealing.

Fortunately, Carla had a host of levers at her disposal—her savings rate while she was working, her retirement age, her spending in retirement, her asset allocation, and her potential job downshift—to secure the outcome she wanted. We estimated that Carla could retire by 66 if she:

- Maintained her savings rate but waited for 15 years before changing jobs and increased the risk level of her portfolio while she was working;
- Upped her savings to $350,000 a year, switched jobs after 10 years, and increased the risk level of her portfolio while she was working; or
- Maintained her savings rate and her conservative asset mix but stayed in her current job. (We forecasted that she could retire early if she moved to a Growth portfolio while she was working.)

Carla had thinking to do, and promised she’d get back to us soon. Meanwhile, she was encouraged that she could meet her goal on her own terms if she evaluated the trade-offs and went with the path that best suited her lifestyle choices.

**CASE STUDY #2: THE "UNLUCKY" INHERITOR**

Ira was 60 years old when he came to us in 1999, and he was confused. He had just inherited $7 million—which delighted him. But he wasn’t sure what he could afford to spend, he didn’t know how much he’d be able to give to his two beloved nieces, and he was very uncertain as to how to invest his newfound money. What he did know is that he didn’t want to be whipsawed by the markets.

Ira had already stopped working, and the inheritance constituted the vast bulk of his funds. Unfortunately, Ira received his inheritance on January 1, 1999, a poor choice of starting dates for an investor. He would face two bear markets (one only a year
At Bernstein, we’ve identified four interrelated species of capital, all of which are critical in helping orchestrate a financial plan:

**Financial capital** is simply money or financial investments. The more you have, the better off you are, but even a great deal of financial capital doesn’t assure you’ll make your goals, if they are unrealistic and overly aggressive.

**Human capital** is the ability to work and generate future savings that can be invested in financial assets. Generally speaking, human capital peaks early in life, nurtured by education, work experience, and on-the-job training. As you work and save, you convert human capital into financial capital. So human capital declines as financial capital rises.

**SECURING YOUR FUTURE NEEDS**

**Target financial capital** is the amount of money you need to be highly confident you’ll have the resources to cover your annual spending needs in the future (when you’re withdrawing funds from your portfolio). In helping clients determine their target financial capital, we focus on how much they want to spend from their portfolios down the road, when they expect to begin this spending, how much investment risk they’re willing to take, and the degree of confidence they require in meeting their goals. For Carla (Case Study #1, page 7), her target financial capital would need to be sufficient to spend about $200,000 a year, in real terms after taxes, once she’s retired.

**Core capital** takes over when target financial capital has been accumulated (see display below), hopefully to a level able to support lifetime spending during the withdrawal phase of investing. Because most of a person’s human capital has been used up by that point, you’ll want to be highly confident that your core capital will be enough to support the lifestyle you want for as long as you live, even if the capital markets are poor and you live a long time. The amount of core capital you need depends on many factors, including your age, your projected spending, the corpus of your financial capital, and your investment asset allocation.

**LIFE PLANNING**

All these forms of capital funnel into your fully developed investment plan: a plan designed to answer your questions about financial security, now and for decades to come. For a deeper analysis of our planning framework, see our research study Live Once, Plan Often.

**GROWING YOUR TARGET FINANCIAL CAPITAL**

Target financial capital is based on the growth of a portfolio, plus cumulative additional savings, until retirement, assuming a confidence level that glides up as human capital declines, so that at retirement it is expected to support sustainable future spending after taxes and inflation. See Note on Bernstein Wealth Forecasting System at the end of this paper for further details.

Source: AB
away), making the 2000s the “lost decade” for stocks. In fact, the US market retreated by 1% per year over that 10-year period. Of course, neither he nor we knew what lay ahead.

**Conservative Assumptions**

Our first task in assuring Ira’s long-term financial comfort was determining a core-capital number (see page 9), assuming a long time horizon and poor markets. Our planning based around core capital is always conservative, because we want to try to assure clients’ financial security even in dismal markets by building them into our plans. So we planned for results poor enough that we’d expect better outcomes 90% of the time.

We found that even under such an assumption, Ira could feel secure that with a moderate 60/40 allocation (and an annual spending budget of $200,000, which he came to regard as reasonable), he’d be able to meet his goals with core capital of $5.9 million. Because Ira was confident that his plan would provide for his needs, he decided to give the $1.1 million surplus to his nieces immediately. Display 7 presents the results for Ira’s wealth through midyear 2015, together with our estimate of his core-capital requirements stretching out for decades.

**Turning “Luck” Around**

The green line in Display 7 is Ira’s core-capital line—downward-sloping from the beginning, because he needs less core capital to support his spending needs as he ages from that point forward. Any investor would want to be at least at core—if not above—all the time. Usually it doesn’t work quite that way because of the short-term vagaries of the markets. But with a plan that provides a solid underpinning, periods below core should be relatively brief and shallow.

Ira’s path of wealth fit that criterion well. It dipped about 14% below core in the bear market of the early 2000s, but then climbed above core in the good years that followed. He fell back below core during the financial crisis of 2008—but recouped the shortfall relatively soon. We don’t want to minimize the anxiety that Ira experienced in the great bear market—but the salient question (for all investors) wasn’t “How much did the market slump?” but rather “What is the effect of the slump on my ability to achieve my long-term plans?”

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**DISPLAY 7: CASE #2**

MAINTAINING AND SURPASSING CORE-CAPITAL NEEDS

Plan vs. Actual Wealth for a 1999 Investor

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Past performance is not necessarily indicative of future results.

*The hypothetical performance of a Moderate Portfolio Simulation, intended to illustrate the investment experience of a Bernstein taxable client who was invested in a 60% equity/40% fixed-income (municipal-bond) allocation of Bernstein investment services. It is presented for illustrative purposes only, and no representation is made that an investor will, or is likely to, achieve profits or experience losses similar to those shown. See Notes on Bernstein Performance Statistics at the end of this paper for additional information.

*Core-capital calculations are based on an allocation of 60% global stocks (35% US value, 35% US growth, 25% developed international, and 5% emerging markets) and 40% intermediate-duration municipal bonds with annual spending of 3.4% (inflation-adjusted). Based on Bernstein’s estimates of the range of returns for the applicable capital markets over the periods analyzed. Data are not a promise of actual future results. See Note on Bernstein Wealth Forecasting System at the end of this paper for further details.

Source: AB
Indeed, between the market recovery in early 2009 and midyear 2015, Ira’s wealth rose well above core—so much so, that at age 77, he now had an enviable choice to make: Should he bank on his wealth increasing further with his moderate-growth allocation, allowing him more discretionary spending and giving him the opportunity to transfer even more assets to his nieces? Or should he de-risk his portfolio in the interest of experiencing greater financial stability in the years ahead? A conservative portfolio allocation would significantly reduce the future volatility of his wealth.

Of course, there’s no one “right” choice here. The correct answer for Ira will depend on his risk tolerance at 77 and his evaluation of the trade-off between growth potential and emotional security. Bernstein’s wealth-forecasting tools give him the wherewithal to make that choice.

Further, the concept of core capital appealed to Ira a lot. He realized that it spoke to his specific circumstances and goals and gave him a customized metric to measure his ongoing progress against his plan objectives. For Ira (and for us) this is a more important benchmark than any market index. Perhaps most important, our systematic, conservative planning had allowed Ira to give his surplus wealth to his nieces—which he otherwise would have been unlikely to do—and enjoy seeing the difference it made in their lives.

CASE STUDY #3: SUSTAINING A FOUNDATION IN PERPETUITY

Andrew and Jennifer, both 55 years old, had sold a successful business some years ago and found themselves with a financial windfall. Philanthropically inclined, the couple had decided to establish a public foundation that they hoped could last into perpetuity, ultimately under the aegis of their children and younger generations. They started the foundation with $10 million in capital, earmarked for a charity committed to helping troubled children and teens move on to mainstream schools.

More Stocks, Please

The primary question for the couple and for us was whether their 60% allocation to stocks and 40% to bonds would allow them to make good on their decision to distribute 5% of the foundation’s value annually while also keeping it whole over time after inflation. They had been successful in attracting about $100,000 (1% of the foundation’s value) each year through outside fund-raising, which they expected to continue. Still, they were fearful of erosion in the foundation’s real value. And they were concerned that the low-return markets that are likely ahead might exacerbate the shortfall.

They came to us wanting to know what they should do about their allocation—which, it turned out, led to other key issues. And as stewards of the foundation, Andrew and Jennifer had the fiduciary duty to make prudent investment decisions. They weren’t at all sure they were living up to this standard—which discomforted them.

To get a handle on the allocation issue, we had our Wealth Forecasting System model 10-year forward-looking returns in typical markets for a spectrum of allocations ranging from 30% to 100% in global stocks (Display 8, next page). We estimated how much of the foundation’s principal could be spent each year above and beyond projected annual inflation. And so the blue section of each bar represents the spending rate that we forecasted would allow the foundation to exist in perpetuity with no diminution of its real value.

If 4% net real spending is the target after the contribution of fund-raising is factored in, it’s clear from the display that a 60/40 allocation for the foundation is likely to fall short. So Andrew and Jennifer were right to be concerned about the depletion of real assets. To meet their spending bogey, a higher allocation to stocks was needed to fuel growth of the foundation’s assets.

We estimated that 80% in stocks would clear the hurdle in typical markets. Andrew and Jennifer were willing to consider reallocation with that in mind, but at the same time they were concerned about the volatility that such a stock-tilted asset mix might entail.

And volatility there would be: With an 80%-stock portfolio, we estimated a looming 71% chance that the foundation’s distributions would decline by at least 20% at some point over the next 10 years. This was troubling in the extreme to Andrew and Jennifer, who felt that their fiduciary duties required them to reduce the risk of such volatile distributions. Was there anything that they could do to bring that 71% figure down?
Reducing Volatility

We took our analysis of the foundation to another level by discussing with Andrew and Jennifer three different strategies for mitigating volatility, any or all of which could be employed (Display 9):

- **Broader investment diversification:** The foundation was invested in only stocks and bonds. But hedge funds, inflation-protected bonds, and real assets are imperfectly correlated with one another and with stocks and traditional bonds: When one asset loses value, another would likely gain. Therefore, allocations to those assets would reduce portfolio fluctuations. We estimated that such a diversification strategy would reduce the risk of a 20% reduction in distributions to 64%.

- **Smoothing out distributions:** One of the problems with designating a set percentage of a portfolio’s value for spending (in this case, distribution to a charity) is that when the markets drop, the distribution will also suffer. On the other hand, when the markets are booming, the distribution will spike. Many charitable donors—Andrew and Jennifer included—are uncomfortable with such pronounced fluctuations, since it’s hard to operate many charitable programs if spending varies too much from year to year.

If diversification is one strategy for mitigating volatility, smoothing out the distributions is another. Smoothing can be accomplished by spending an average of the portfolio’s market value over the prior several years, usually three. The value of smoothing is that it helps keep the annual changes in spending more gradual.

By diversifying assets and employing three-year smoothing, we estimate that the odds of a 20% drop in annual distributions could be cut in half in average markets—from 71% to 35%, as indicated in Display 9. But that’s not the end of the story.

- **Matching assets to liabilities—fund-raising:** Andrew and Jennifer’s Bernstein Advisor also addressed the fund-raising piece of the foundation puzzle. Foundations typically depend in great measure on direct gifts.
of cash and appreciated securities to support their distributions. That’s fine, up to a point. But direct gifts to charity tend to dry up in difficult markets, when they are needed most. So the Advisor suggested that the couple ask some of their donors to give charitable trusts and annuities, in addition to (or instead of) direct gifts.

Vehicles such as charitable remainder trusts, charitable lead trusts, and charitable gift annuities share several valuable characteristics that make them popular with high-net-worth donors: They offer the donor or a beneficiary whom he or she designates either regular income or a remainder payment. They can help the donor diversify his assets, if he gives highly appreciated stock to a trust. And all offer tax deductions, though the terms of the deduction (as well as the taxability of any payments to the donor) vary from vehicle to vehicle.

These vehicles could also help the foundation gain long-term sources of income (from charitable lead trusts) or lump sums (from charitable remainder trusts or gift annuities). The Advisor offered to help Andrew and Jennifer’s trusts-and-estates attorney model the finer points of gifting strategies, so that the couple could have concrete and actionable conversations with prospective donors.
We estimated that in combination, diversifying the foundation’s asset mix, smoothing its distributions, and diversifying its long-term funding sources would reduce the odds of a 20% drop in distributions to little more than one-in-four. That was a risk Andrew and Jennifer could live with. Like Carla and Ira, they were pleased that they had so many levers they could pull to reach their goal.

CONCLUSION: THE RIGHT END OF THE TELESCOPE

Good advice can help you avoid costly investment mistakes, such as chasing past performance or switching wholesale into and out of asset classes, or being paralyzed by severe markets. The value of avoiding those mistakes can be quantified: For example, fleeing stocks for three years after the financial meltdown cost the 80/20 investor on page 6 almost half his wealth.

But the total value of good investment advice is much harder to quantify, because it goes to the life choices and the financial security of investors. In our first case study, investment advice helped Carla clarify the alternative routes she could use to secure her family’s financial future. In our second case study, it gave Ira the confidence to gift money to his nieces and stay invested through two unnerving bear markets. For Andrew and Jennifer in our third case study, our advice helped them fine-tune their foundation’s asset allocation, spending policy, and fund-raising strategy to provide a sustainable path for their foundation over time. In all these cases, our holistic approach to wealth management proved beneficial.

We started this paper arguing that too many investors look through the wrong end of the telescope when assessing their future security. They focus on distracting data and lose sight of what really counts. At Bernstein, we train our focus precisely on the target that matters to each investor, keeping him on track to meet his goals.
NOTES ON BERNSTEIN PERFORMANCE STATISTICS

The hypothetical performance of the Moderate Portfolio Simulation is presented for illustrative purposes only. The performance shown is hypothetical because it does not represent the performance of actual managed accounts. The results may not reflect the impact that certain material economic and market factors may have had on actual decision-making for managed accounts. No representation is being made that an investor will, or is likely to, achieve profits or experience losses similar to those shown.

The Moderate Portfolio Simulation (MPS) is a simulated portfolio intended to illustrate the investment experience of a Bernstein taxable client who was invested in a 60% equity/40% fixed-income (municipal-bond) allocation of Bernstein investment services. The specific allocations within the MPS have changed over time as new investment services were introduced, or as a result of changes in Bernstein’s asset-allocation recommendation. From January 1999 through December 2005, the MPS is rebalanced to a 60/40 allocation on a quarterly basis. From January 2006 through June 2015, the MPS is rebalanced to a 60/40 allocation on a monthly basis. Each return is calculated by multiplying the actual return of the product by its weight in the blend, then summing these weighted returns. These returns are then geometrically linked, or compounded, to calculate cumulative and/or annualized rates of return for various time periods. Although a 60/40 allocation was maintained over time, the specific blend of products in the portfolio changed with the inception of new products. Pooled-investment vehicles were organized under the Investment Company Act of 1940, as amended, managed by AllianceBernstein L.P.

The specific allocations for returns were as follows:

1. From January 1999 through June 2001: 21% Bernstein US Strategic Value, 21% Bernstein US Strategic Growth, 40% Bernstein Intermediate Municipal Bonds (accounts over $3 million), 15% developed foreign markets pooled-investment vehicle, 3% emerging markets pooled-investment vehicle.

2. From July 2001 through March 2007: 18.5% Bernstein US Strategic Value, 18.5% Bernstein US Strategic Growth, 35.0% Bernstein Intermediate Municipal Bonds (accounts over $3 million), 15.0% developed foreign markets pooled-investment vehicle, 3.0% emerging markets pooled-investment vehicle, 10.0% real estate pooled-investment vehicle.

3. From April 2007 through December 2008: 19.2% Bernstein US Strategic Value, 19.2% Bernstein US Strategic Growth, 35.0% Bernstein Intermediate Municipal Bonds (accounts over $3 million), 13.8% developed foreign markets pooled-investment vehicle, 2.8% emerging markets pooled-investment vehicle, 10.0% global real estate pooled-investment vehicle.


5. From April 2010 through June 2012: 14.7% Bernstein US Strategic Value, 14.7% Bernstein US Strategic Growth, 28.0% intermediate diversified municipal bonds pooled-investment vehicle, 10.5% developed foreign markets pooled-investment vehicle, 2.1% emerging markets pooled-investment vehicle, 18.0% Tax-Aware Overlay A pooled-investment vehicle, 12.0% Tax-Aware Overlay B pooled-investment vehicle.

6. From July 2012 through September 2012: 29.4% Bernstein US Strategic Equities, 28.0% intermediate diversified municipal bonds pooled-investment vehicle, 10.5% developed foreign markets pooled-investment vehicle, 2.1% emerging markets pooled-investment vehicle, 18.0% Tax-Aware Overlay A pooled-investment vehicle, 12.0% Tax-Aware Overlay B pooled-investment vehicle.

7. From October 2012 through October 2014: 25.34% Bernstein US Strategic Equities, 24.14% intermediate diversified municipal bonds pooled-investment vehicle, 9.05% developed foreign markets pooled-investment vehicle, 1.81% emerging markets pooled-investment vehicle, 15.52% Tax-Aware Overlay A pooled-investment vehicle, 10.34% Tax-Aware Overlay B pooled-investment vehicle, 13.80% Multi-Manager Alternative (RIC) pooled-investment vehicle.

8. From November 2014 through June 2015: 25.52% Bernstein US Strategic Equities, 23.76% intermediate diversified municipal bonds pooled-investment vehicle, 8.80% developed foreign markets pooled-investment vehicle, 1.76% emerging markets pooled-investment vehicle, 0.88% Muni Bond Inflation pooled-investment vehicle, 1.76% All Market Real Return pooled-investment vehicle, 16.72% Tax-Aware Overlay A pooled-investment vehicle, 8.80% Tax-Aware Overlay B pooled-investment vehicle, 12.0% Multi-Manager Alternative (RIC) pooled-investment vehicle.

Details on the performance of constituent services are available upon request.
NOTE ON BERNSTEIN WEALTH FORECASTING SYSTEM

Bernstein’s Wealth Forecasting SystemSM is designed to assist investors in making long-term investment decisions regarding their allocation of investments among categories of financial assets. Our planning tool consists of a four-step process: 1) Client Profile Input: the client’s asset allocation, income, expenses, cash withdrawals, tax rate, risk-tolerance level, goals, and other factors; 2) Client Scenarios: in effect, questions the client would like our guidance on, which may touch on issues such as when to retire, what his/her cash-flow stream is likely to be, whether his/her portfolio can beat inflation long term, and how different asset allocations might impact his/her long-term security; 3) The Capital Markets Engine: Our proprietary model, which uses our research and historical data to create a vast range of market returns, takes into account the linkages within and among the capital markets, as well as their unpredictability; and 4) A Probability Distribution of Outcomes: Based on the assets invested pursuant to the stated asset allocation, 90% of the estimated ranges of returns and asset values the client could expect to experience are represented within the range established by the 5th and 95th percentiles. However, outcomes outside this range are expected to occur 10% of the time; thus, the range does not establish the boundaries for all outcomes.

Expected market returns on bonds are derived taking into account yield and other criteria. An important assumption is that stocks will, over time, outperform long-term bonds by a reasonable amount, although this is in no way a certainty. Moreover, actual future results may not meet Bernstein’s estimates of the range of market returns, as these results are subject to a variety of economic, market, and other variables. Accordingly, the analysis should not be construed as a promise of actual future results, the actual range of future results, or the actual probability that these results will be realized.

Asset-class projections used in this paper reflect initial market conditions as of June 30, 2015. They include the following median forecasts of 20-year compound rates of return: US diversified stocks (represented by the S&P 500 Index): 6.3%; US value stocks (S&P/Barra Value Index): 6.7%; US growth stocks (S&P/Barra Growth Index): 6.0%; US small-/mid-cap stocks (Russell 2500 Index): 6.6%; developed international stocks (MSCI EAFE Index unhedged): 7.3%; emerging-market stocks (MSCI Emerging Markets Index): 5.4%; municipal bonds (AA-rated diversified municipal bonds of seven-year maturity): 3.0%; US taxable bonds (seven-year maturity): 3.6%; global taxable bonds, hedged (50% sovereigns and 50% investment-grade corporates of developed countries, with seven-year maturities): 3.0%; real assets (1/3 FTSE EPRA/NAREIT Index, 1/3 MSCI ACWI Commodity Producers Index, 1/3 DJ-UBS Commodity Index): 6.1%; diversified hedge funds (Diversified Hedge Fund Asset Class): 5.3%; and inflation (Consumer Price Index): 2.4%.

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