STEWARD

MARCH 2016

A QUARTERLY PUBLICATION OF ALLODIUM INVESTMENT CONSULTANTS ■ VOLUME 9, ISSUE 1

What Drives Market Returns?

There are many benefits of diversifying your investments to minimize avoidable risks, manage the unavoidable ones that are expected to generate market returns, and better tolerate market volatility along the way. Let's focus on how to build your diversified portfolio for effectively capturing those expected returns. This calls for understanding where those returns actually come from.

The Business of Investing

With all the excitement over stocks and bonds and their ups and downs in headline news, there is a key concept often overlooked. ***Market returns are compensation for providing the financial capital that feeds the human enterprise going on all around us, all the time.***

When you buy a stock or a bond, your capital is ultimately put to hard work by businesses or agencies who expect to succeed at whatever it is they are doing, whether it's growing oranges, running a hospital or selling virtual cloud storage. You, in turn, are not giving your money away. You mean to receive your capital back, and then some.

The Fascinating Facts About Market Returns

So what *does* drive expected returns? There are a number of factors involved, but among the most powerful ones spring from unavoidable market risks. As an investor, you can expect to be rewarded for accepting the market risks that remain after you have diversified away the avoidable, concentrated ones.

Consider two of the broadest market factors: **stocks (equities)** and **bonds (fixed income)**. Most investors start by deciding what percentage of their portfolio to allocate to each. Regardless of the split, you are still expecting to be compensated for all of the capital you have put to work in the market. So why does the allocation matter?

When you buy a bond …

- You are **lending** money to a business or government agency, with no ownership stake.
- Your returns come from **interest** paid on your loan.
- If a business or agency defaults on its bond, you are closer to the **front** of the line of creditors to be repaid with any remaining capital.

When you buy a stock …

- You become a **co-owner** in the business, with voting rights at shareholder meetings.
- Your returns come from **increased share prices** and/or **dividends**.
- If a company goes bankrupt, you are closer to the **end** of the line of creditors to be repaid.

In short, stock owners face higher odds that they may not receive an expected return, or may even lose their investment. There are exceptions. A junk bond in a dicey venture may well be riskier than a blue-chip stock in a stable company. But this is why stocks are generally considered riskier than bonds and have generally delivered higher returns than bonds over time.

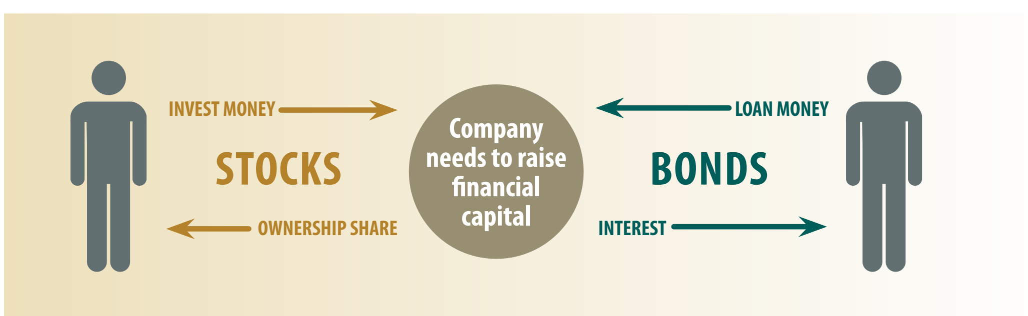
This outperformance of stocks is called the **equity premium**. The precise amount of the premium and how long it takes to be realized is far from a sure bet. That's where the risk comes in. But reflecting back at stock-versus-bond performance over time, it's easy to see that stock returns have handily pulled ahead of bonds over the long-run … but also have exhibited a bumpier ride along the way. Higher risks AND higher returns show up in the results.

Your Take-Home

Exposure to market risk has long been among the most important factors contributing to premium returns. At the same time, ongoing academic inquiry indicates that there are additional factors contributing to premium returns, some of which may be driven by behaviors other than risk tolerance. Over the years, the evidence has always led us to build broadly-diversified portfolios with a significant allocation to both stocks and bonds.

David Bromelkamp

President and CEO



NEW EMPLOYEE SPOTLIGHT:
Zachary Knudson

Role at Allodium: Administrative Assistant

Joined firm on: February 8, 2016

University attended: Hamline University

Hometown: Isanti, MN

Favorite movie: Passengers

Favorite book: *How to Win Friends and Influence People* by Dale Carnegie

Favorite TV show: Parks and Recreation

Favorite food(s): Chinese Food, Donuts/Pastries

Favorite news source: *Forbes Magazine*

Favorite gadget: Chromecast

Favorite activity: Gardening and Landscaping

Person I admire most: My Former Professor Peggy Andrews

What I'm most thankful for: Growing up in a small, friendly town

SPOTLIGHT

Headlines

- Congratulations to David Bromelkamp, Anne Ward and Eric Hutchens for receiving the Five Star Wealth Manager award for 2016 as recognized in the January 2016 issue of *Mpls.St.Paul Magazine*.
- David Bromelkamp is looking forward to presenting for the Minneapolis/St. Paul Chapter of the Nonprofit Financial Group in March as well as at the National fi360 Insights Conference in April.
- Allodium was pleased to welcome three new clients in the fourth quarter of 2015.
- Our office will be closed on March 25th and May 30th for company holidays.

Note: *To find out more about Allodium's breaking news, please visit the blog on our website www.aicria.com.*

WE APPRECIATE YOUR INTRODUCTIONS

To optimize our objectivity and avoid conflicts of interest, we are a fee-only registered investment advisor that is completely independent from banks, brokerage firms and other financial product providers.

If you know someone who may be looking for this type of objective investment advice, please contact Dave Bromelkamp at 612-230-3702 or dbromelkamp@aicria.com to arrange a friendly, no-obligation introduction.

Steward is published quarterly by Allodium Investment Consultants. Please contact Zachary Knudson at 612-230-3704 or zknudson@aicria.com if you have any comments about this publication or wish to be added to or removed from our mailing list.

ALLODIUM® INVESTMENT CONSULTANTS 2005 10 YEARS 2015