THE NEW DIVERSIFICATION
Asset Allocation into 2023

By Kelly Fitzpatrick, Product Manager

After a volatile 2020 and 2021, markets finally closed lower in 2022. Both stocks and bonds lost value, showing retail investors what advisors have known for some time: The inverse correlation between stocks and bonds isn't what it used to be. But what does this mean for portfolio managers? When we looked at how Advyzon firms were invested as of December 31, 2022, we noticed a new focus on alternative investments and commodities.

In all the years Advyzon has been reporting firms' asset allocations, alternative investments have never made up even 1% of total allocations. The highest allocation came in 2015 at 0.78%. So while the nearly 3% we saw allocated to alternative investments in 2022 may seem like a small allocation overall, and it is, it represents a threefold increase in advisor interest in alts.

Because of this, we decided to dig a little deeper into how advisors are approaching alternative investments, talking to an Advyzon firm that specializes in private investment as well as experts in the field of liquid alts.

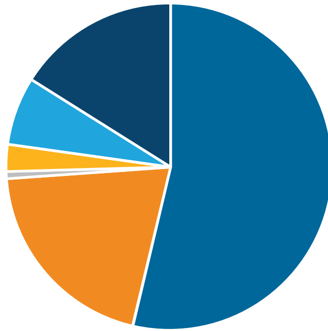
But we're not looking at alts exclusively, we're also going to breakdown how advisory firms shifted their thinking toward equities and bonds, as well as the growing shift from mutual funds to ETFs. Before we do that, though, let's start at the beginning: overall allocations.

At the end of 2022, the more than 1,200 firms using Advyzon to report on their portfolios had just under 54% in stocks, just over 20% in bonds, 6.7% in cash, 2.7% in alts, just over half a percent in commodities and just over 16% in "other" investments, some of which may be classified as alternative investments but not tracked as such.

Those numbers are a shift from the close of 2021—advisors shifted money out of equities and cash and invested in alts and "other" investments. We also saw ETFs finally overtake mutual funds as the investment vehicle of choice for advisory firms.

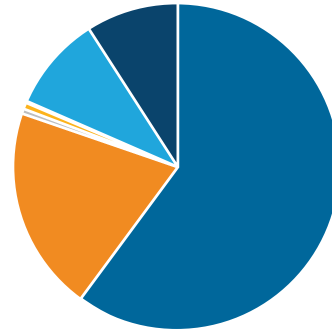
Let's dig into the specifics.

Allocation by Asset Class: 2022



■ Equities ■ Fixed Income ■ Commodities ■ Alternatives ■ Cash ■ Other

Allocation by Asset Class: 2021



■ Equities ■ Fixed Income ■ Commodities ■ Alternatives ■ Cash ■ Other

Finally, Brian Huckstep, Chief Investment Officer of Advyzon Investment Management (AIM), highlighted a few trends to be mindful of when reviewing the data on the following pages.

"We've seen a huge surge in certificates of deposit (CDs) into client portfolios. CDs that paid less than 1% at the end of 2021 may be yielding more than 5% today. That massive yield increase inspired many advisors who hadn't previously used CDs to start introducing them to client portfolios," Huckstep said. "This didn't just happen in income-driven portfolios, we saw advisors add CDs to growth portfolios."

This may not be immediately clear in the data, however. Many advisors access CDs through money market mutual funds, which may be categorized as cash or other. Often, the precise classification of CDs is determined by the firm or advisor.

Huckstep also highlighted that markets in 2022 were driven primarily by inflation and interest rates, and while that trend held for the first half of 2023, the focus going forward is likely to shift away from the Fed and back toward corporate earnings.

As you read through the rest of this white paper, consider the following:

- Earnings growth took a hit recently. Inflation drove costs up across the board: operating expenses, materials costs, capital expenditure and overhead have increased across industries. Many corporations haven't been able to pass these costs on to consumers in the form of higher prices; highly regarded brands tend to have more success with this. Huckstep posits strong brands may do better in this environment. (In other words, think high quality investing).
- The beginning of 2023 saw growth stocks make a comeback, but value stocks are still relatively attractive when you compare today's P/E to historical valuations.
- Buying the dip on intermediate bonds may be tempting after last year's 13% drop, but Huckstep warns that we may see the inverted yield curve steepen even further. "We've been overweight short-term bonds for a couple years and aren't in a hurry to reintroduce long-term bonds until yields increase past 4%," he said.
- Whether you love or hate the 60/40 portfolio, Huckstep points out that all else equal, this foundational allocation is priced more attractively in 2023 than a year ago.

We hope these takeaways help contextualize this data for you. After all, past performance (and allocations) doesn't predict future results, but it can help you hone forward-looking
investment strategies.

Without further ado, let's get started with the most popular allocation.

EQUITIES

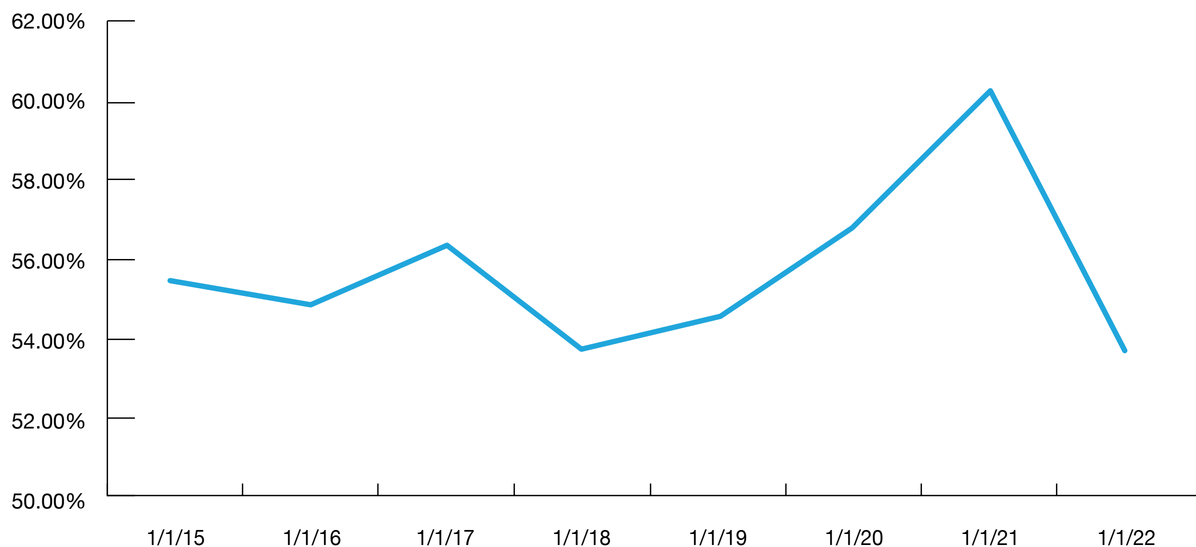
The amount of client assets in stocks at the end of 2022 fell significantly from the end of 2021; however, the move may not be as dramatic as it sounds when you add a bit of context. First, this move takes us closer to historical equity allocations.

From the close of 2015 to the end of 2020, the amount of client money in stocks held steady around 55%. In 2021, however, that allocation jumped to nearly 60%.

With that context in mind, the shift to 54% in equities by the end of 2022 makes sense—it's roughly a return to the baseline. However, it is a dip below the average. The last big drop in equity allocations happened in 2018 following Fed rate hikes, and allocations climbed steadily after that by about 1% a year. Depending on how volatility and economic headwinds play out, we may see something similar in equity allocations going forward.

Beyond that, at least a portion of the shrinking equity allocation was due to poor performance versus outflows. We asked AIM CIO Brian Huckstep to look at how much poor stock market performance may have impacted the data.

"U.S. stocks were down 18% in 2022 while U.S. bonds were down just 13%. That math explains roughly half of the drop in equity exposure from 60% to 54%," he explained. Adding that "the drop in equity ownership across accounts is not a complete surprise."



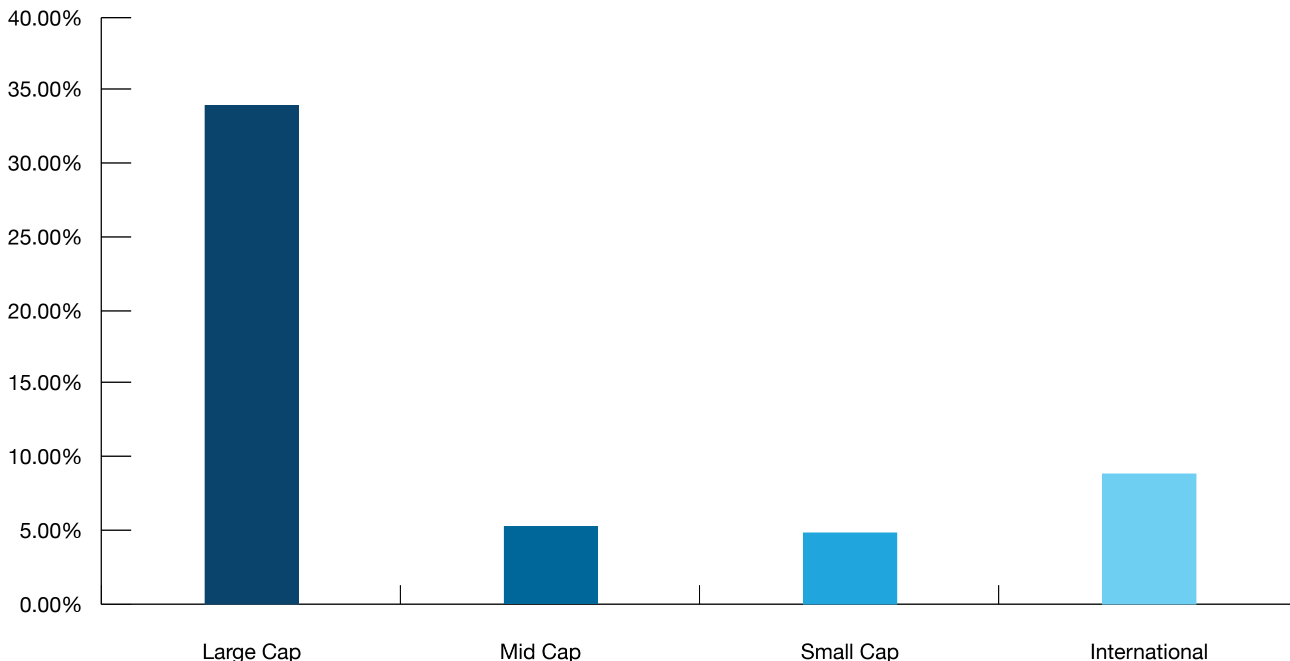
Let's take a minute to look past the overall equity allocations into the types of stocks advisors favored in 2022. Overall, firms have been slowly increasing their investments in large-cap stocks year after year. At the end of 2022, firms had just over 34% invested in large-caps, up from 33.6% at the end of 2021 and 31% at the end of 2020. The prior two years were just over 29%.

Small-caps saw a slight dip in 2022. Advyzon data shows firms tend to allocate 4-6% to small-caps historically, so while the 4.89% firms had in small-caps at the end of 2022 represented a dip, it's well within the range.

Mid-caps were the one sector to buck the trend in 2022. Advisors had more than 9% allocated to mid-caps at the end of 2021; that number fell to 5.2% in 2022.

When it comes to how advisors think about capitalization, Huckstep points out that mega-caps, the four to seven firms that are valued at $1 trillion or more on any given day, have driven market performance and returns for the past decade. And those returns, fueled by ready capital for research and development, have been outsized. These returns have therefore overshadowed solid performance in small- and mid-cap stocks. "While academics posit that small-caps produce outsized returns over time, this hasn't been the case in the past decade," explained Huckstep. "Many investors have lost interest."

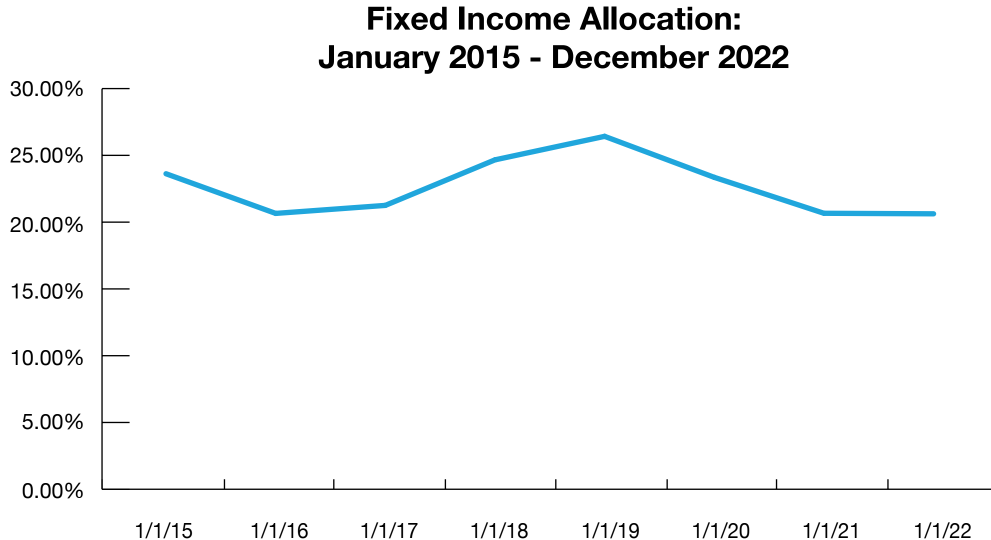
Firms also reduced their investments in international stocks last year. For several years, advisors place roughly 10% of their allocation into international equities; at the end of 2022, that number was 9.1%.



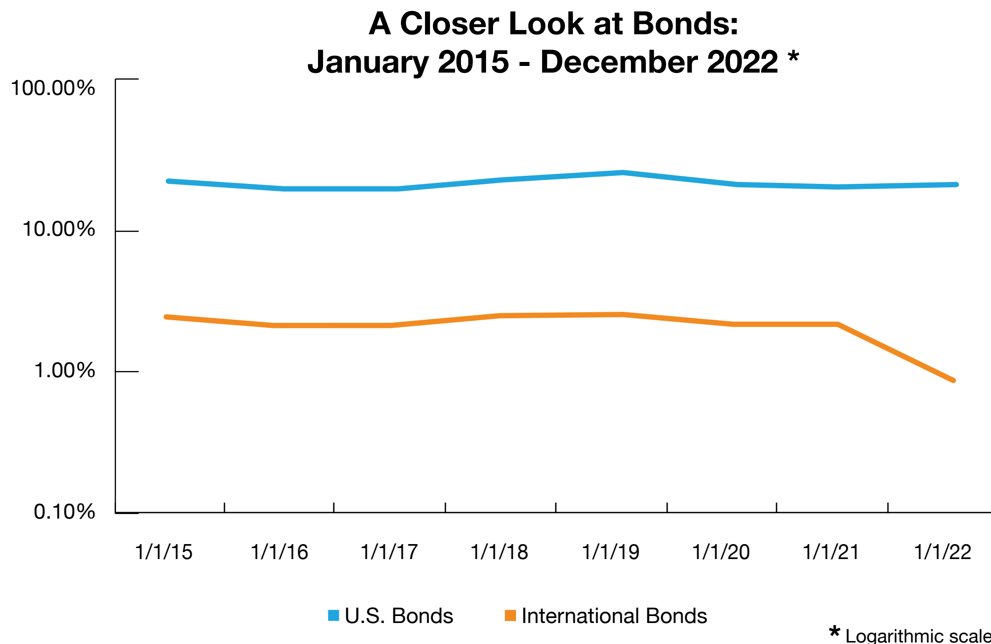
"International stocks seem to have lost their luster in the same way small-cap stocks have," said Huckstep. Once again, he suggests it's all down to returns. "Both developed and emerging market equities have underperformed their U.S. counterparts for the past 20 years. That kind of performance gives investors pause. Not to mention, the globalization of U.S. companies decreases the need for international holdings as a diversification tactic."

FIXED INCOME

For years, advisors have kept their fixed income allocation fairly constant—somewhere in the range of 20-25% of client assets. The end of 2022 showed more of the same. In fact, the amount of client funds allocated to bonds at the end of 2021 was nearly identical to the end of 2022—20.32% and 20.82%, respectively.



We did see a shift in the type of bonds firms invested in. At the close of 2022, firms invested less than 1% of client money into international bonds. For nearly a decade, that number has been closer to 2%. Much like the alternative investment numbers, this isn't a substantial shift from overall portfolio management, but does appear significant when you combine the move away from international equities.

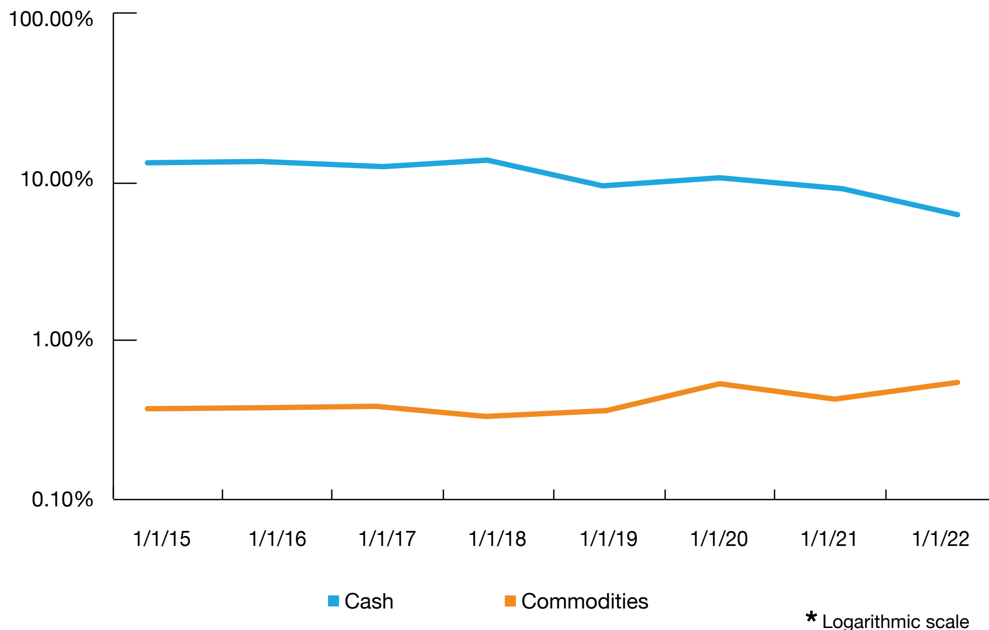


One last thing to note on fixed income: The number of advisors investing directly in bonds increased in 2022. We'll dig into this more on page 11 when we look beyond asset class.

CASH AND COMMODITIES

As far as cash and commodities go, advisory firms pulled money out of cash and put money into commodities. Overall, however, the commodity allocation remains small; less than 1% of overall client assets.

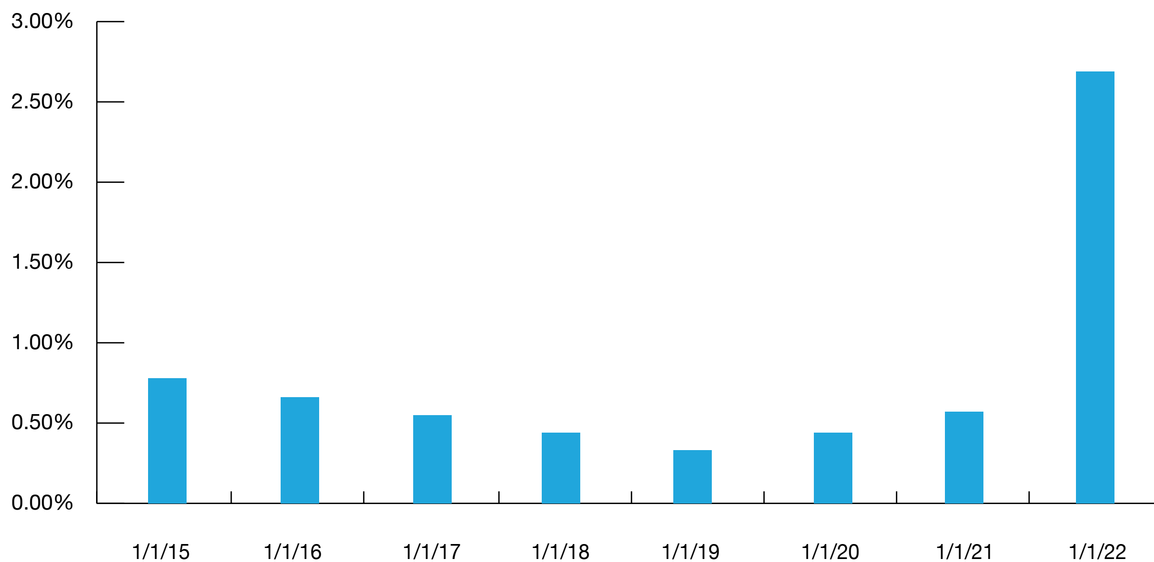
On the cash side, the 6.7% advisory firms allocated towards cash at the end of 2022 is the lowest we've seen in this study's timeframe. From the close of 2015 to the close of 2020, between 10-14% of client assets were in cash or cash equivalents. In 2021, that number fell to 9.5%, breaking through that 10% threshold, before falling again last year to 6.7%.



One explanation for these outflows may be the big increase on yield for cash equivalent products, including certificates of deposit (CDs). As we mentioned in the introduction to this white paper, products like CDs can be classified in different ways; it's possible some of the outflow from cash and into the "other" allocation may be down to how CDs and short-term fixed income products are classified.

ALTERNATIVES AND "OTHER" INVESTMENTS

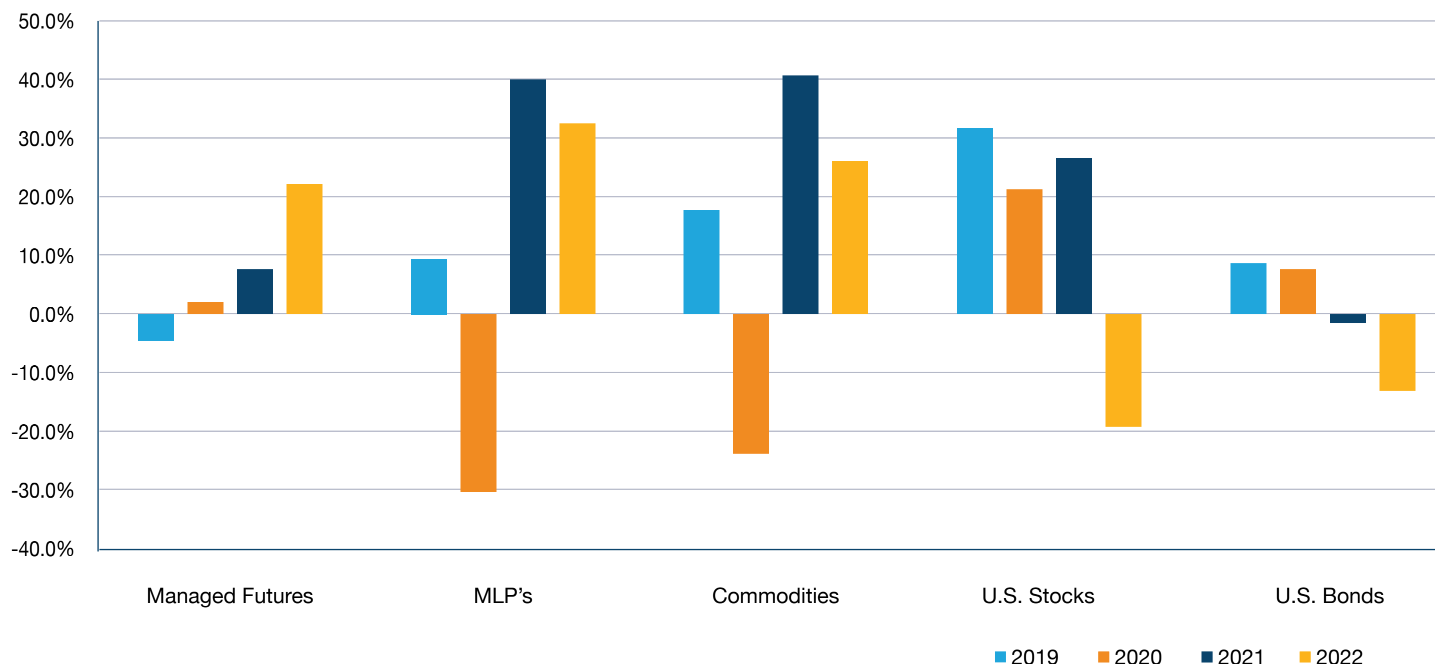
By far the biggest winners in 2022, as far as client asset allocations, were alternative investments and "other" investments. As we mentioned in the introduction, while alternative asset allocations remained relatively small, they've increased significantly over previous years.



For this study, the definition of "alternatives" aligns with Morningstar classifications and tends to refer to liquid alts—think managed futures, long-short equities and option-driven funds.

However, there are some alternative investments, including illiquid alt strategies, that fall into the "other" category. Consider that not all "other" investments are alternatives—blended funds, preferred shares, and similar investments all fall into this category.

While advisors often look to alts as a way to diversify beyond stocks and bonds, diversification may not have been the only factor at play in 2022. These assets outperformed significantly last year. Huckstep points out that these outsized returns are a long time in the making. Managed futures underperformed stocks in 2019, 2020, and 2021. Master limited partnerships (MLPs) posted outsized losses along with commodities in 2020.



However, this low correlation is precisely the point of alternative allocations. Huckstep puts it this way: "The way alternatives performed in 2022 reminded investors that diversification often takes a full market cycle (7 to 10 years) to do its job."

And finally, alts are more accessible now than they were just a decade ago, meaning it's easier to tap into this kind of diversification. Shana Sissel, CEO of Banríon Capital Management (a platform that helps advisors access and learn about alternative investments), puts it this way:

> *The availability of alternatives is far greater than ever before. From hedge-fund-like mutual funds to ETFs and the advent of interval funds, the average investor can now access the diversification benefits that alternatives bring. 2022 demonstrated the value of evolving the traditional 60/40 portfolio to include an allocation to low-correlation alternatives.*

SPOTLIGHT ON ADVISOR ALTS

For many advisors, the sheer size and complexity of the alternative investment market can be a turnoff. While it's easy for large, institutional funds to look toward alternatives (the average institutional fund allocates roughly 20-25% of their portfolios to alts), the market is largely untapped by retail investors and their advisors.

Liquid alts have helped change that; after record inflows into liquid alts in 2021, the increases continued through 2022. But liquid alts aren't the only option.

Consider Crossgrain Family Investments, an advisory firm out of Richmond, Virginia, serving high net worth clients. For co-founders Jeffrey Mussatt and William (Biff) Pusey, working private market investments into their investment strategy was a given from the start.

Pusey, for instance, started his career in venture capital before managing a family office; because his family office bolted on to an RIA, he was able to learn the more traditional public investing side of portfolio management while continuing to explore nontraditional investments. Pusey and Mussatt continued that model with Crossgrain, managing their own families' money alongside client assets in a high-alignment business model.

This can make longer-term or less liquid private market investments easier to explain and market to clients. When Crossgrain puts client money into an opportunity, they're invested alongside their clients.

"We do a good job in public markets," said Pusey in a recent interview with Advyzon. "But our expertise, our experience, our leanings, are into the private investment world because that's what we do best."

> "But our expertise, our experience, our leanings, is into the private investment world, because that's what we do best.."

For firms that may not be as experienced in private markets (which for Crossgrain includes private credit and lending, real estate opportunities, venture capital and private equity accessed via direct investments, co-investments, and fund investments), new platforms like CAIS, Banríon Capital Management, and iCapital may provide a helpful gateway into the space.

While many advisors focus on the diversification these new alternative platforms provide, the appeal for Pusey goes beyond diversification. He's heavily focused on the way private investments reduce volatility and force investors to focus on long-term, risk-adjusted performance.

When it comes to systemic risk, Pusey said that while many private companies face similar systemic risks to their public counterparts, they face less scrutiny of their day-to-day operations. There's less pressure to report an "earnings beat" each quarter.

(You may remember Warren Buffett recently called investor focus on quarterly and annual GAAP earnings one of the "shames of capitalism.")

In private markets, leaders can take a longer-term approach to investing. It can be easier to make tougher decisions on margins and management during challenging markets or economies since there's less pressure to deliver consistent short-term returns.

Still, private markets—and the broader world of alternative investments—can feel intimidating in both complexity and scope. We asked Banríon CEO Shana Sissel how advisors can get started in alts if they aren't totally familiar with the different products and investment solutions.

"It's important to understand that building alternative allocations is no different than building equity or fixed income. Focus on reviewing the universe of options to find the building blocks to create the low correlation basket that offers the greatest diversification."

She added that it's important to understand the liquidity limitations of an alternative allocation. "While interval funds allow for access to things like private real estate, private equity, and private credit, they are limited in their liquidity. Understanding a client's tolerance for this illiquidity is critical to set appropriate expectations."

For advisors interested in exploring alternatives, Advyzon offers data integrations with CAIS and other platforms. We can also help build specialized integrations to reflect the way you interact with private markets or other alternatives. For instance, the Crossgrain team shared the metrics and formats they wanted to report, and how they wanted those metrics incorporated and displayed alongside public investments, and the Advyzon team was able to build a system to import key data points. Crossgrain clients get quarterly reports that express performance across managers, asset classes, and vintage years.

"It's important to understand that building alternative allocations is no different than building equity or fixed income. Focus on reviewing the universe of options to find the building blocks to create the low correlation basket that offers the greatest diversification." – Shana Sissel, Banríon Capital Management CEO

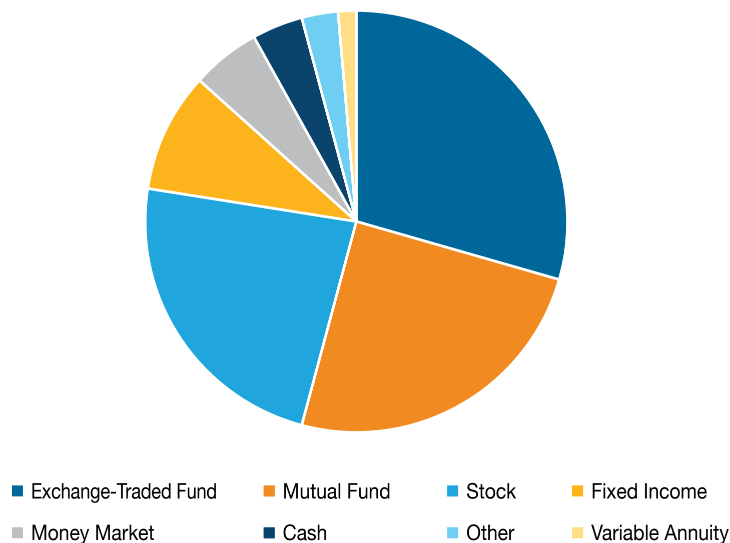
BEYOND ASSET CLASS: HOW ADVISORY FIRMS INVEST

Two big headlines when it comes to the vehicles advisors were using to invest client money at the end of 2022. First: ETFs officially replace mutual funds as the most popular investment vehicle. Second: Investments in bonds (versus bond funds) nearly doubled between 2021 and 2022.

Advyzon firms used ETFs to handle roughly 28.5% of client assets at the close of 2022. That's roughly the same level as we saw in 2021. Mutual funds, however, saw outflows according to our data. Advisors had just under 24% of client money in mutual funds at the close of 2022, down from more than 30% at the close of 2021.

According to AIM CIO Brian Huckstep this is a trend 30 years in the making—"It started when State Street launched SPY as the first ETF in the U.S. From the start the tax benefits, liquidity, and relatively low cost made ETFs attractive to investors."

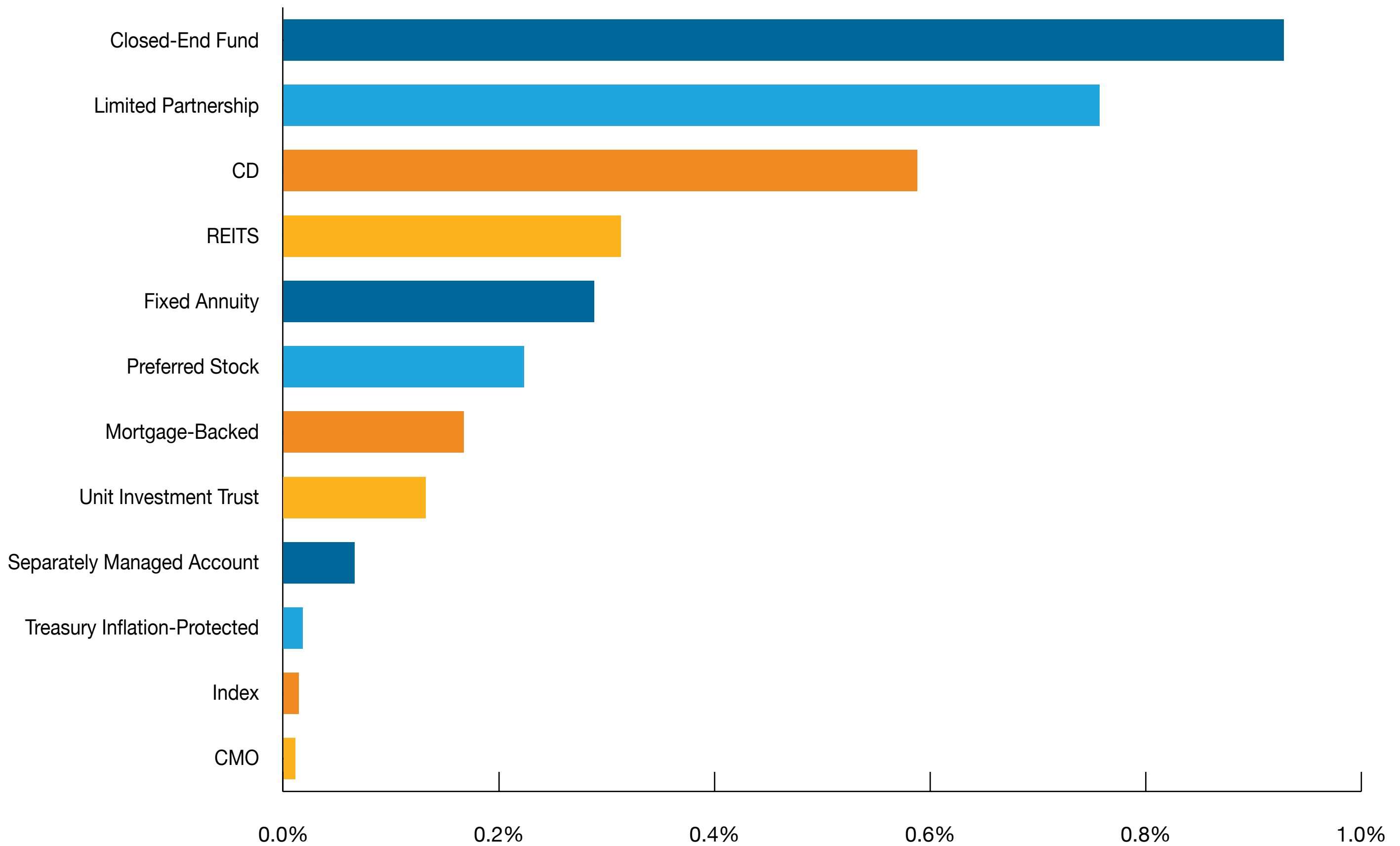
Breakdown by Security Type: 2022



Interestingly, advisors may have shifted away from owning individual stocks—22.4% at the close of 2022 compared to 23.5% at the close of 2021. Bonds, however, saw an increase. Advisors had more than 8.9% invested directly in fixed income at the close of 2022, up from about 4.9% at the end of 2021.

Because bond funds fall under either mutual funds or ETFs, depending, this allocation to fixed income shows an increase in advisors holding physical bonds. This may be down to a shift in advisor focus from the volatility of total return funds to the consistent (and increasing) yield payments of individual bonds in 2022. As the Fed debates future rate hikes, it will be interesting to see whether more advisors shift their focus from price to yield.

We did also want to breakdown some of the less popular security types. We only included security types with at least .01% of client assets in this rendering. One notable move? Cryptocurrency fell off the list, using this metric. While advisors had roughly 0.01% of client assets in crypto at the close of 2021, that fell to just .005% by the close of 2022.



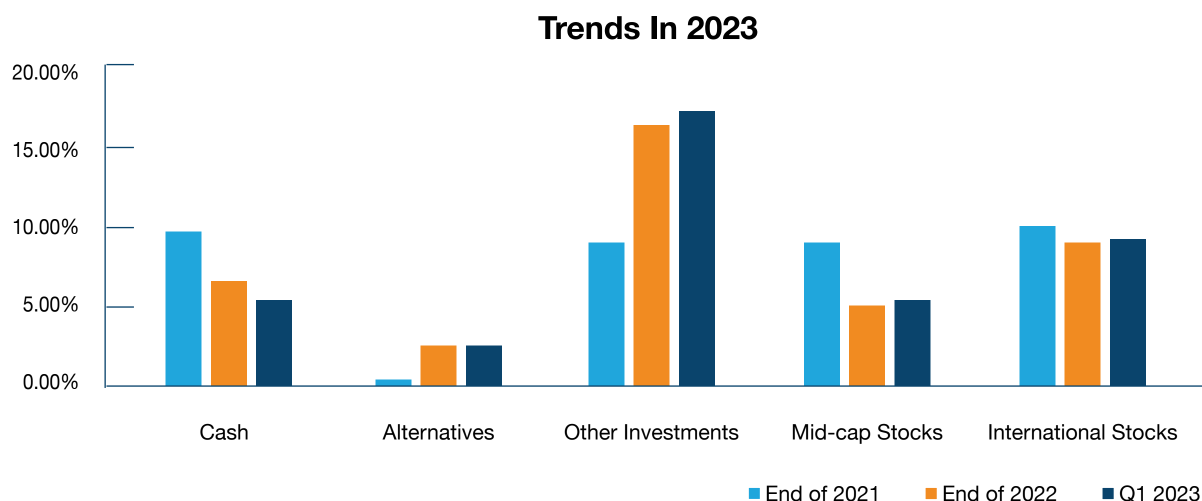
As far as top security holdings across all investment vehicles, Apple and Microsoft once again topped the list at the end of 2022. Advyzon firms had more than $2.2 billion in client assets invested in Apple and nearly $1.4 billion in Microsoft.

In third place, Vanguard's Total Stock Market ETF leapfrogged over SPDR's S&P 500® ETF. This may be due to expense ratios. The SPDR ETF, ticker SPY, has an expense ratio of 0.09% while the Vanguard fund, ticker VTI, charges 0.03%.

WHAT ALL THIS MEANS FOR 2023

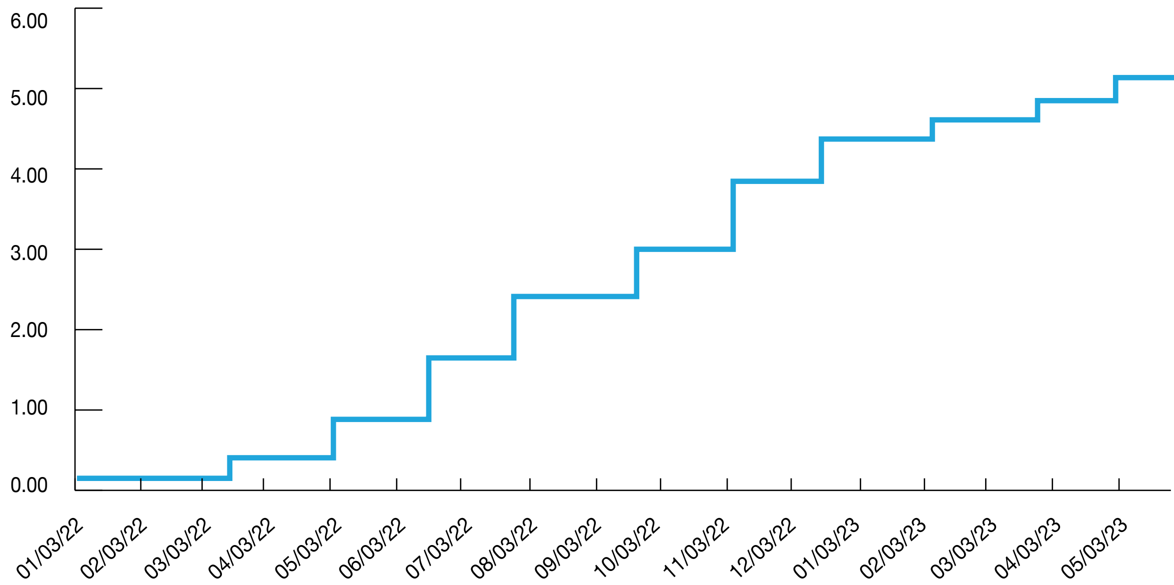
We wanted to see if these trends were holding in 2023, and if they might indicate where we're headed in the months to come. So we pulled the same data, looking at how advisors are allocating client money across broad and super asset classes, for the first quarter of 2023. Here's what we found:

- **Advisors are pulling money out of cash.** We saw advisors significantly decrease the amount of client assets in cash at the close of 2022, going from 10% or more in recent years to 9.5% at the end of 2021, 6.7% at the end of 2022, and 5.5% at the end of Q1 2023.
- **Alternatives and "other" investments seem to be holding steady.** The amount of client money allocated to official alts fell by about 10 basis points in the first quarter, while investments in "other" assets ticked up by about 1%.
- **The inverted yield curve may be driving both trends.** The still-inverted yield curve (as of June 2023) means products like CDs offer higher yields than basic cash accounts. The varied classifications of these higher-yielding cash equivalent products may be fueling the shift from cash toward other.
- **Rethinking equities.** We saw small shifts in how advisors allocated their equity holdings. While mega-caps are outperforming significantly so far in 2023, several large layoffs fed general concerns about a potential recession. In this environment, we saw some money move back into both mid-cap and international stocks in the first quarter. Mid-caps shifted from 5.2% to 5.5% and international equity allocations grew from 9.1% to 9.4%. These moves are relatively small and may reflect market valuations versus any adjustment to advisor holdings in the first quarter.



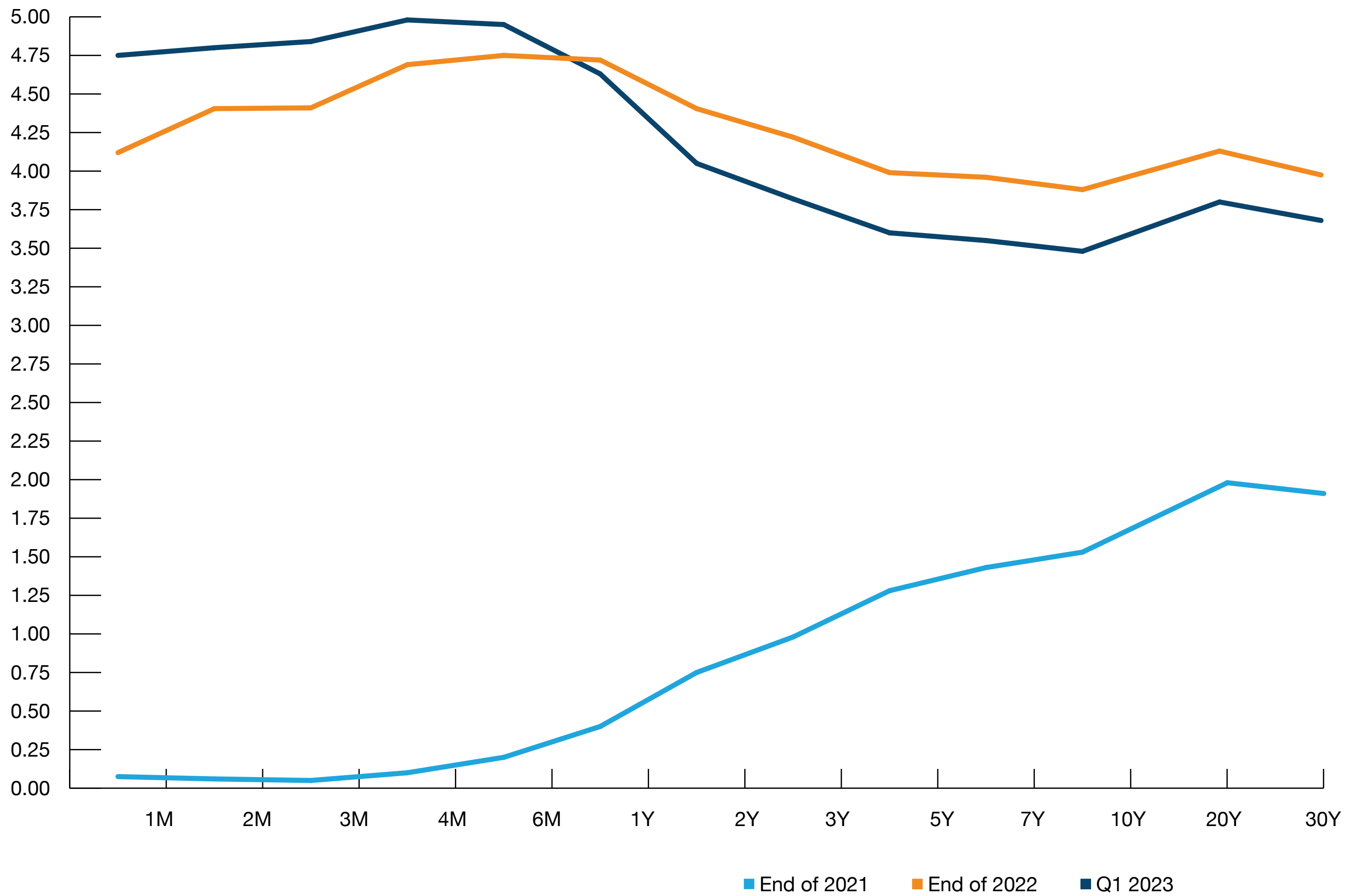
Of course, all data requires context, and the elephant in the room for the past two years has been inflation and a series of rate hikes form the Federal Reserve. As of June 2023, the Fed has paused but signaled future hikes may be coming. If key inflation numbers, such as CPI (the go-to inflation metric for retail investors and government agencies) and PCE (the inflation indicator used by the Fed), continue to come down, the pause in rate hikes may continue.

Federal Funds Effective Rate



Beyond inflation, an important metric to watch in 2023 is jobs. After all, the Federal Reserve is mandated to strive for full employment. So far, we've seen major layoffs in tech—Meta, Amazon, Microsoft, and Google, to name a few. Disney also laid off a significant number of employees. While these job cuts seem limited to specific sectors and regions as of now, layoffs at major companies may trickle out to impact their suppliers and contractors in unpredictable ways.

Remember: The yield curve inverted in 2022 and remains steeply inverted as of June 2023. According to research from the Federal Reserve, a yield curve inversion has preceded every U.S. recession since the 1970s. That said, there's usually a time lag between the inversion and any economic downturn. Plus, an inverted yield curve doesn't tell us how long or significant an economic downturn may be.


Yield Curve End of 2021, End of 2022, End of Q1 2023
5.00
4.75
4.50
4.25
4.00
3.75
3.50
3.25
3.00
2.75
2.50
2.25
2.00
1.75
1.50
1.25
1.00
0.75
0.50
0.25
0.00
1M
2M
3M
4M
6M
1Y
2Y
3Y
5Y
7Y
10Y
20Y
30Y
End of 2021
End of 2022
Q1 2023

All of this factors into outlooks for the second half of 2023. As AIM CIO Brian Huckstep pointed out earlier in this white paper, as the focus shifts away from Fed policy it's likely to shift toward earnings. That means we could see more shifts in how advisors allocate across equities. Focusing on earnings may shift the way advisors allocate to growth and value as well as small- and large-cap.

We may also see shifts in how advisors invest across different bond durations. While we stuck with aggregate funds in this report, advisors have shifted how they think about short-, intermediate- and long-term debt over the past few years. That's likely to continue.

Of course, the bond market saw action beyond the yield curve this spring. The collapse of several banks drove up the yield on high-interest debt, which increased the spread between that high-yield corporate debt and U.S. Treasuries. This spread is finally normalizing as of June 2023.

If you want professional help thinking through some of these variables, Advyzon can help. As we wait to see whether the bull market is really back or we're simply in the calm before a recession, you may want to shift your focus away from portfolio management and toward client engagement.

Advyzon Investment Management offers holistic portfolio management via a turnkey asset management program (TAMP), and access to professionally managed portfolio models via the new Nucleus model marketplace. Depending on how hands-on you want to be going forward, Advyzon has options to support you with informed market analysis, portfolio models, and trade assistance.

If you aren't sure how to adjust client allocations in the coming months, **consider setting up a demo** to see how Advyzon may be able to support you through the uncertainty.