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# PORTFOLIO CONSTRUCTION

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**Janney**

# PORTFOLIO CONSTRUCTION



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Mike Halloran is an Equity Strategist with more than 25 years of experience as a strategist, mutual fund analyst and investment banker. He analyzes all asset classes with particular emphasis on equity research.

Mike received his M.B.A. from Carnegie Mellon University and is a former aerospace research engineer with engineering degrees from the University of Florida and University of Pittsburgh.

A home and investment portfolio are two of the most important family assets. There are also many similarities between a well-constructed portfolio and a well-constructed home. Both are built on solid foundations guided by time-tested fundamental principles. In addition, they both feature characteristics that are tailored to the owner's specific needs and desires. **This report reviews the fundamental guiding principles of a well-constructed portfolio.**

## PART 1

### THE FUNDAMENTALS

Similar to a home, the foundation of a portfolio is critical. Prudent portfolio management is based on three, long-standing, fundamental investment principles.

1. **Asset allocation** is the strategic blend of asset classes such as stocks, bonds, and cash—is dictated by a client's specific investment objectives and risk tolerance. Market timing strategies do not play a significant role in determining a client's asset allocation.
2. **Diversification** is regarded as the primary tool for reducing risk. A properly diversified portfolio will limit risk without sacrificing return potential.
3. **Security selection** is based on a fundamental understanding of the risk and potential reward of each investment, viewed with a long-term perspective, within the context of a client's overall portfolio structure.

A well-constructed portfolio begins with a diverse mix of high-quality stocks and bonds, and cash. High-quality stocks have a history of outperforming most other assets and are critical for maintaining an investor's purchasing power over the long run. Investment-grade (high-quality) bonds offer current income and diversification, which helps reduce portfolio volatility (described later in this report). Cash is important for unexpected "rainy day" expenses, provides income and diversification, and can be used to take advantage of timely investment opportunities.

Figure 1: Building a Portfolio



- A. **Foundation:** Asset allocation, diversification, and security selection.
- B. **2x4 Columns:** Stocks (large-cap or blue-chip, small-cap, international). **Bonds** (investment-grade, municipal, high-yield). **Money Market Funds.**
- C. **Roof:** Cash.

*Source: Investment Strategy Group*

### VOLATILITY AND IMPORTANCE OF CORRELATION

Just as support beams and roof trusses must be properly fastened to the foundation of a home, securities must be properly assembled to form a well-constructed portfolio. Diversification and correlation play critical roles in this.

While stocks outperform other asset classes over long periods of time, this outperformance comes with wide variations in yearly performance. This demonstrates the risk or volatility associated with owning stocks. While bonds have historical returns that are lower than stocks, the yearly return variation is lower with bonds—demonstrating the lower risk of owning bonds. While the historical return from cash is lower than stocks and bonds, the yearly return variation is also much lower—demonstrating the low-risk nature of owning cash.

### Return vs Risk

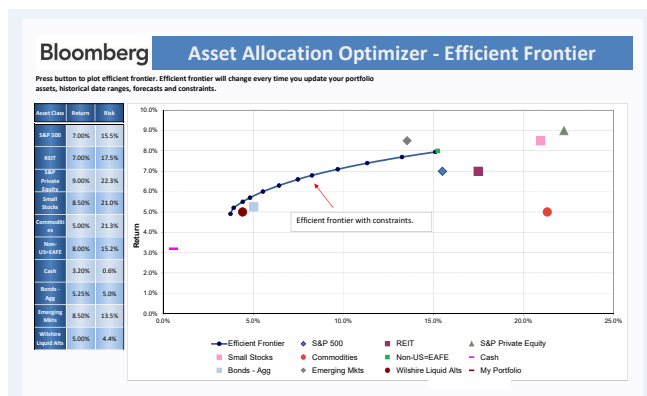
All of this leads to the concept of return vs risk—the higher the return an investor is seeking, the more risk they must be willing to accept. Conversely, a risk-averse investor must be willing to accept lower potential returns.

Correlation measures the manner in which two securities move relative to each other. Positively correlated securities tend to move up and down together. Negatively correlated assets tend to move opposite each other. A critical element of portfolio construction is combining assets that are not highly correlated with each other. Importantly, stocks and investment-grade bonds are negatively correlated, which provides a major reason for including both of these assets as key structural elements in a portfolio. By combining these two assets, portfolio risk can be reduced for any given level of expected return.

Utilizing historical return, risk (variation in yearly returns), and correlation characteristics of various assets, optimal portfolios can be estimated that minimize risk for any given level of expected return. This is known as determining the “efficient frontier,” or optimal combination of assets that maximizes return while minimizing risk.

Figure 2 shows the trade-off of return vs risk for various asset classes and includes the efficient frontier—notice the efficient frontier defines the highest expected return at any given level of risk. The lower left portion of the curve represents lower risk (high weight in cash and bonds) but also lower returns. The upper right portion represents higher potential returns (high weight in stocks and other risky assets) but also greater exposure to risk.

Figure 2: Trade-off of Risk and Return



Sources: Janney Investment Strategy Group; Morningstar

## PORTFOLIO CONSTRUCTION CORE PRINCIPLES

- Owning stocks is critical for maintaining purchasing power. Stocks have significantly outperformed every major asset class over long periods of time.
- Diversification matters. Asset class returns vary from year to year and diversification can greatly reduce portfolio volatility. A balanced portfolio reduces volatility while maintaining long-run returns.
- Investment time horizon is critical for investment success. While yearly returns can be volatile, holding a diversified portfolio for longer time periods usually results in significant, positive returns.

VALUE IN 2024 OF \$1,000 INVESTED IN 1926	
Small-Cap Stocks	\$ 38,168,837
Large-Cap Stocks	\$ 13,654,260
Corporate Bonds	\$ 326,163
U.S. T-Bills	\$ 24,781
U.S. Inflation	\$ 17,582

See appendix for more details

## PART 2

### CUSTOMIZING A PORTFOLIO

Homebuilders typically don't give too many options when it comes to the type of foundation or 2x4s that will be used in the construction process—similar to how portfolios should start with blue-chip stocks and investment-grade bonds.

The foundation should include stocks from all major sectors of the economy, including Technology, Health Care, Consumer Discretionary and Staples, Financials, Industrials and Materials, Energy, Communication Services, Real Estate, and Utilities. Similarly, bonds should represent diverse economic sectors, with maturities staggered to mitigate reinvestment risk.

However, homebuyers have many options when it comes to color schemes, appliances, and landscaping. In a similar vein, investors have many options to tailor their portfolio for their risk tolerance and unique circumstances after the sturdy foundation of their portfolio has been established.

### Risk Tolerance

A risk-averse investor usually accepts a lower expected portfolio return and chooses the lower volatility associated

with owning a higher portion of bonds and cash. Risk-tolerant investors are willing to accept the higher volatility associated with owning stocks and typically choose a higher percentage of stocks and other higher-risk assets (Figure 3).

### Tax and Savings Considerations

For investors in a high tax bracket, including a significant portion of municipal bonds in the foundation is most likely appropriate.

The cash portion of a portfolio is also highly dependent on an individual's circumstances. For most investors, the minimum level of cash to keep on hand is an emergency fund that would cover typical expenses for at least six months. Emergency funds allow you to get through unexpected life events without having to sell off your assets at an inopportune time.

### Diversification

Similar to the landscaping of a new home, investors can put finishing touches on their portfolios by adding international stocks and bonds, individual stocks, or other assets (including precious metals) that they may have a high conviction on.

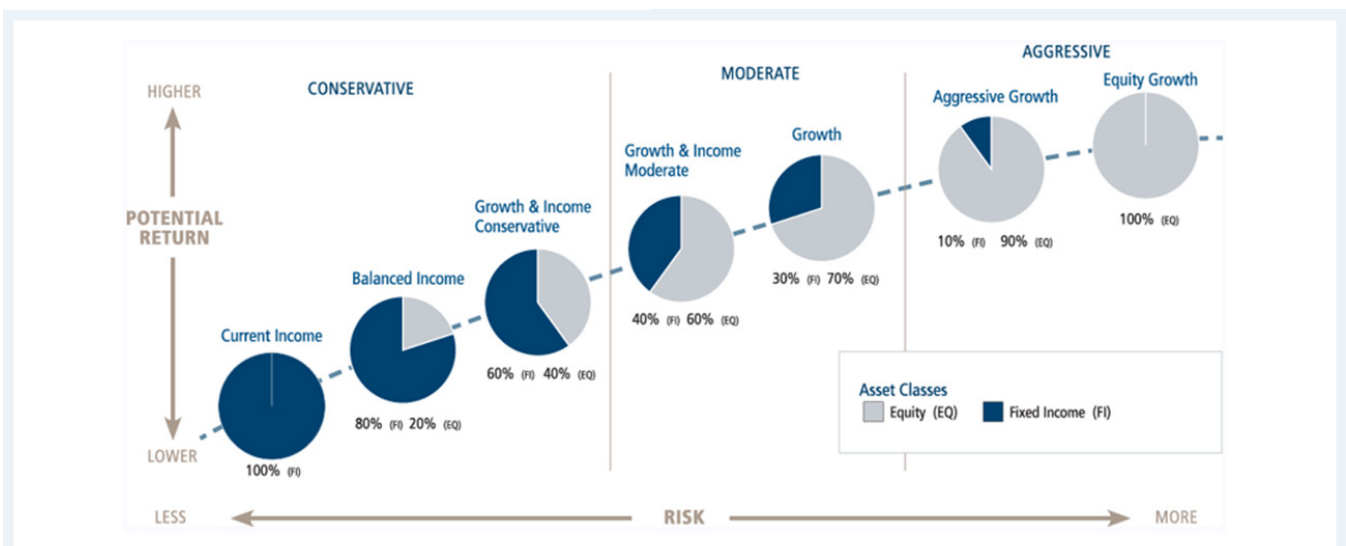
International markets present both strategic and tactical opportunities for portfolios, with China and other emerging markets becoming important investment stories over just the last two decades. Amazon (founded in 1994), Alphabet (Google's parent firm, founded in 1998), and Facebook (2004)

are relatively young companies that quickly grew to become dominant global firms—creating lots of wealth along the way.

Investors can use opportunities now to build wealth and enhance their future investment landscape.



Figure 3: Risk Tolerance Scale



Source: Janney Investment Strategy Group

Figure 4: Representative Portfolios

ASSET CLASS	EXPECTED RETURN (%)	EQUITY GROWTH PORTFOLIO WEIGHTS (%)	DIVERSIFIED GROWTH PORTFOLIO	60/40 BALANCED PORTFOLIO	40/60 BALANCED PORTFOLIO	DIVERSIFIED INCOME PORTFOLIO	INCOME PORTFOLIO WEIGHTS (%)
Large-Cap Stocks	7.0	50	40	30	20	10	0
Small/Mid-Cap Stocks	8.5	10	8	6	4	2	0
Developed International Stocks	8.0	14	11	8	6	3	0
Emerging Market Stocks	8.5	5	4	3	2	1	0
Private Equity*	9.0	7	6	5	3	2	0
Real Estate	7.0	5	4	3	2	1	0
Investment-Grade Bonds	5.25	0	18	35	52	69	88
Private Debt*	6.75	0	2	4	6	8	10
Hedge Funds	5.0	3	2	2	1	1	0
Commodities	5.0	4	3	2	2	1	0
Cash Equivalents (U.S. Treasuries)	3.2	2	2	2	2	2	2
Expected Portfolio Return	—	7.3	6.9	6.5	6.1	5.7	5.4

Sources: Janney Investment Strategy Group, Horizon Actuarial Services, Morningstar

\* Private equity and debt weightings are assumptions with actual values determined by portfolio liquidity needs.

This table summarizes the Janney Investment Strategy Group’s long-term outlook for the major asset classes and includes representative weightings and returns for equity growth and income portfolios. Please see the **Long-Term Capital Market Assumptions 2025** report for additional details about recommended portfolio allocations and expected returns.

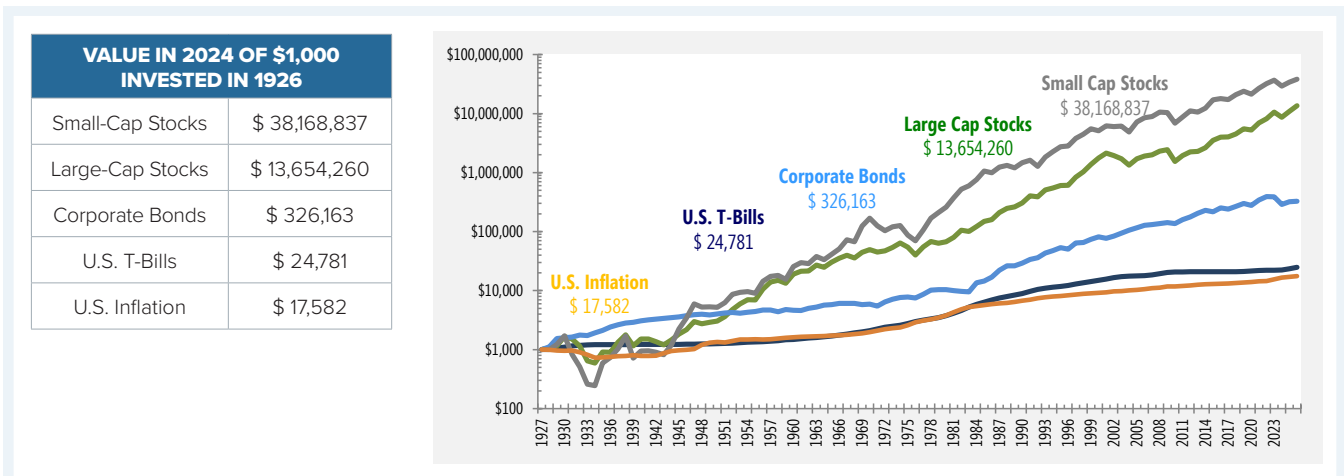
## APPENDIX

### Equity Exposure is Key to Portfolio Growth

Stock exposure is important for portfolio growth and maintaining long-term purchasing power.

- Compounding returns can be powerful over time, despite bouts of volatility.
- Stocks have significantly outperformed every major asset class during long periods of time.
- While we face significant economic challenges today, stocks significantly outperformed during the last 90 years, which included numerous economic and market challenges.

Figure 5: Value in 2024 of \$1,000 Invested in 1926



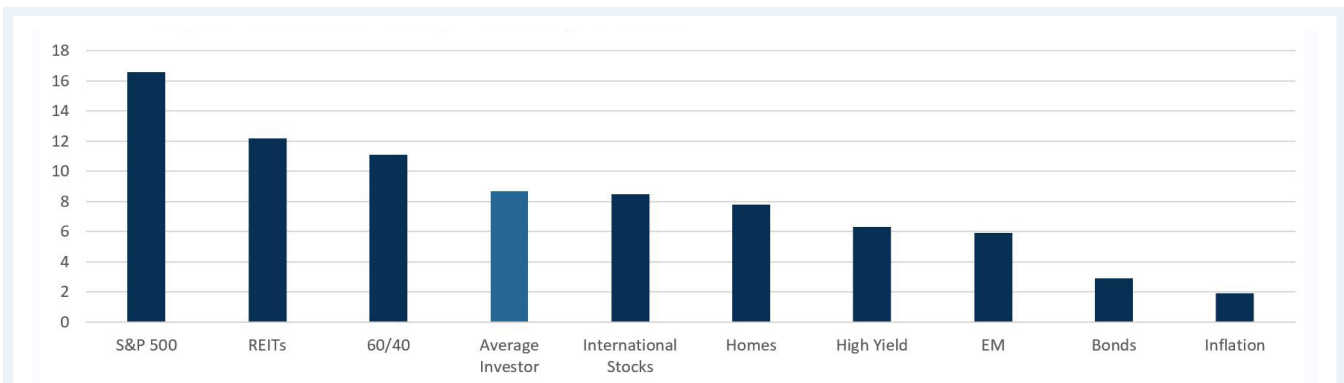
Sources: Janney ISG, Bloomberg, Barclays, Standard and Poor's, Russell and BEA

### Market Timing and Lack of Diversification

Studies have shown the average investor can underperform because of poor market timing and a lack of portfolio diversification.

Investors are usually best served by focusing on long-term returns and maintaining a diversified portfolio, including considering some exposure to risky assets. A major threat to portfolio returns is short-term emotional decisions related to market volatility.

Figure 6: 10-Year Annualized Returns by Asset Class (2001-2021)



Sources: Janney Investment Strategy Group, J.P. Morgan, and Dalbar Inc.

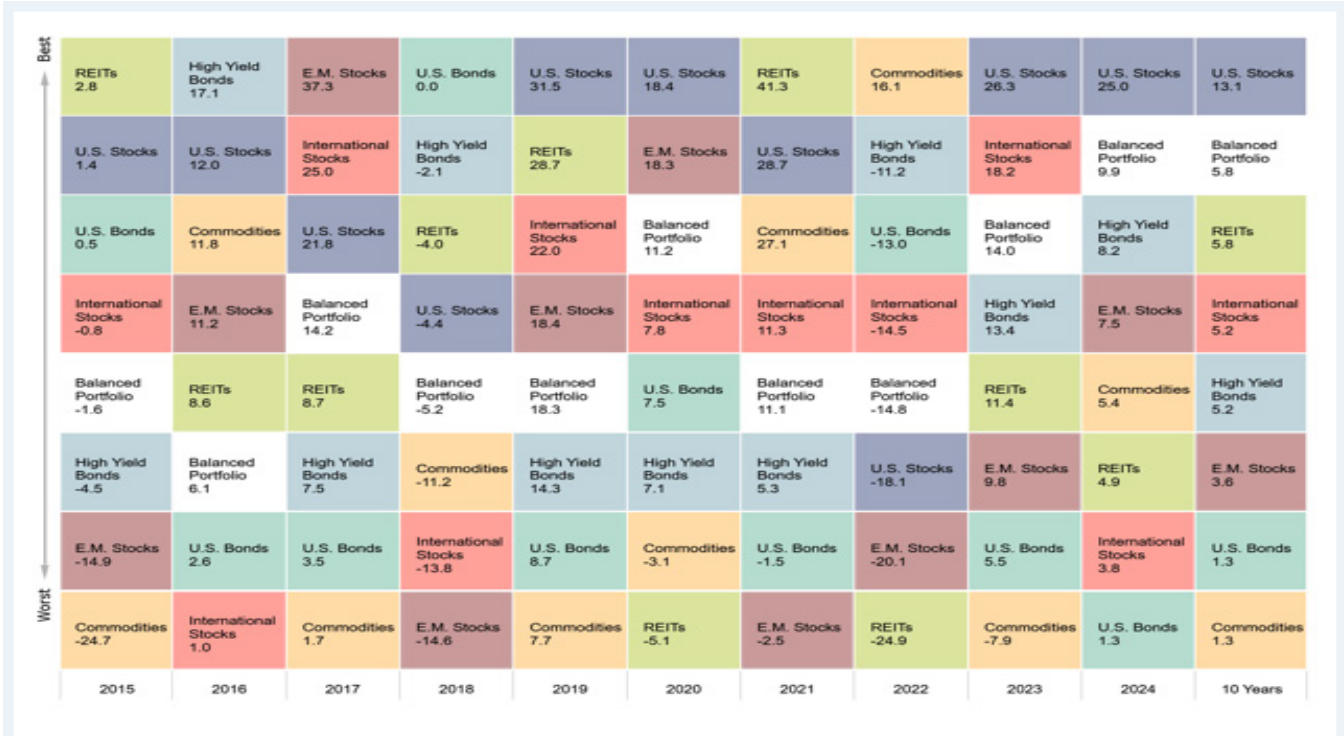
Indexes used are as follows: REITS: NAREIT Equity REIT Index, High Yield: Bloomberg Barclays Global HY Index, EM Stocks: MSCI EM, Bonds: Bloomberg US Aggregate Bond Index, International Stocks: MSCI EAFE, Homes: median sale price of existing single-family homes, Inflation: CPI. 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high quality U.S. fixed income, represented by the Barclays U.S. Aggregate Index. Average investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior.

## Diversification Reduces Yearly Volatility

Asset class returns vary from year to year and diversification can greatly reduce portfolio volatility.

A balanced portfolio reduces volatility while maintaining long-run returns.

Figure 7: Periodic Table



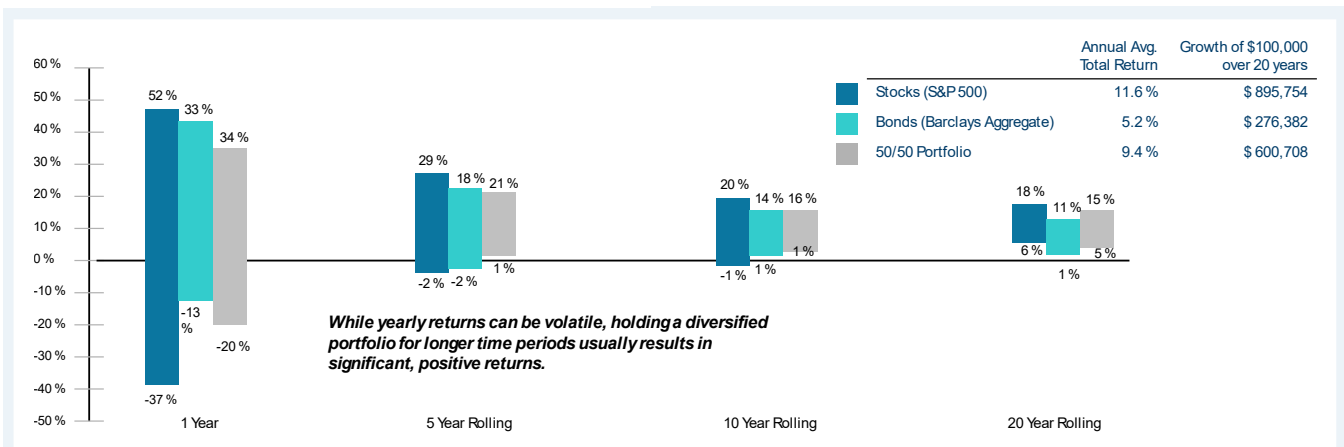
Source: Morningstar  
Index definitions and disclosures on last page of this report

## Time and Diversification are Critical

While yearly returns can be volatile, holding a diversified portfolio for longer time periods usually results in significant, positive returns.

Figure 8: Range of Stock, Bond, and Blended Returns

Annual total returns, 1950–2024



Sources: Janney Investment Strategy Group, Bloomberg, Barclays, Standard & Poor's

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## APPENDIX DEFINITIONS AND DISCLOSURES

**The S&P 500 Index** is widely regarded as the best single gauge of the U.S. equities market. The index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. The S&P 500 Index focuses on the large-cap segment of the market; however, since it includes a significant portion of the total value of the market, it also represents the market.

**The Russell 2000 Index**<sup>®</sup> measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

**The MSCI ACWI (All Country World Index)** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets.

**The MSCI EAFE Index (Europe, Australasia, Far East)** is a free float-adjusted market-capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

**The MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

**The Barclays Global High Yield Index** is a multicurrency flagship measure of the global high-yield debt market. The index represents the union of the U.S. High Yield, the Pan-European High Yield, and Emerging Markets (EM) Hard Currency High Yield Indices. The high yield and emerging markets sub-components are mutually exclusive. Until January 1, 2011, the index also included CMBS high-yield securities.

**The Barclays US Capital Aggregate Bond Index** is an unmanaged, broad-based index consisting of Treasury securities, Government agency bonds, Mortgage-backed bonds, publicly issued US Corporate and specified foreign debentures and secured notes that are rated investment grade (Baa3/BBB or higher) by at least two ratings agencies, have at least one year to final maturity and have at least \$250 million par amount outstanding.

**The Bloomberg US Aggregate Bond Index** is an unmanaged, broad-based index consisting of Treasury securities, government agency bonds, mortgage-backed bonds, publicly issued U.S. corporate and specified foreign debentures and secured notes that are rated investment grade (Baa3/BBB or higher) by at least two ratings agencies, have at least one year to final maturity, and have at least \$250 million par amount outstanding.

**The NAREIT EQUITY REIT Index** is designed to provide the most comprehensive assessment of overall industry performance and includes all tax-qualified real estate investment trusts (REITs) that are listed on the NYSE, the American Stock Exchange or the NASDAQ National Market List.

**The Bloomberg Commodity Index** and related sub-indices are composed of futures contracts on physical commodities and represents twenty-two separate commodities traded on U.S. exchanges, with the exception of aluminum, nickel, and zinc.

**The Bloomberg Barclays Long Term Corporate Bond Index** is designed to measure the performance of U.S. corporate bonds that have a maturity of greater than or equal to 10 years.

**ISG Balanced Portfolio** assumes the following weights: 51% MSCI ACWI, 3% Bloomberg Commodity Index, 3% NAREIT Equity REIT Index, 3% Alternative Investments, 40% Barclays Capital Aggregate.

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