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Investment Guide

Five Myths About Asset Allocation

Richard A. Ferri, 06.28.10, 12:00 AM ET

In recent years there have been a lot of inflated claims made about the benefits of asset allocation. During the last bear market investors discovered just how inflated. Asset allocation (really just a fancy name for diversification) isn't a panacea. It won't protect you in a bear market, and there is no "optimal" asset allocation, no matter what the computer-model promoters say.

Nevertheless, setting a sensible asset allocation is, like controlling investment costs, a key part of smart long-term investing. Neither effort is going to insulate you from a market crash. But over time both disciplines improve your odds of achieving reasonable returns. So it's time to separate the asset allocation myth from the reality.

Myth 1: Asset allocation protects you from the bear.

Asset allocation is all about identifying fundamentally different asset classes (stocks, bonds, real estate investment trusts), deciding how much of each you want to own and selecting investments that represent these asset classes for your portfolio. I prefer to represent asset classes with index funds and ETFs because they're low cost, they are tax efficient and they track the asset classes closely. But you could make the same allocations with actively managed funds.

The goals of asset allocation should be twofold: to set a long-term risk and return expectation for your portfolio and to reduce the probability of a large loss along the way. It is no surprise that the more risk you decide to take, the higher return you might expect. But asset allocation is also sold as a way to diversify risk. The notion is that each asset class in a portfolio carries different risks, which helps reduce the total long-term risk in a portfolio and smoothes out short-term swings.

Here's the key: Asset allocation reduces the probability of a large loss in a down market, but it doesn't prevent a loss. In an economic downturn your portfolio will go down according to the amount of total risk you hold. There's no getting around it.

As for different assets carrying independent risks, that's only true up to a point. These independent risks can be overwhelmed by a larger global economic risk that causes all risky investments to go down together. That's what happened in 1987, 1994, 1998, 2001, 2008 and this year. The Greek debt crisis sent U.S. stocks, foreign stocks and corporate bonds all down together.

Wall Street, fixated on selling investment products, doesn't do a good job of revealing this reality. Investors piled into commodities and hedge funds during 2007 and early 2008 because they were told that these investments weren't correlated with stocks and would protect them in a bear market. But these risky assets fell right along with everything else in 2008 and early 2009, leaving some investors shocked. They shouldn't have been.

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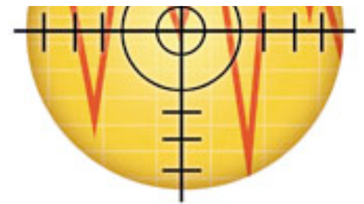
Myth 2: Tactical allocation is best in volatile markets.

There are two different schools of asset allocation. The first follows a "strategic" approach calling for investments to be allocated according to your long-term needs and held at a fixed percentage regardless of market conditions. The portfolio is rebalanced annually to



put the investments back at their strategic target mix. In contrast, the "tactical" asset allocation school shifts asset-class weights based on near-term predictions of returns. A tactical asset allocation may last from a few days to a few years.

Tactical asset allocation is the biggest con game on Wall Street. People want to believe that somewhere, somehow, someone can tell them where to put cash now, and they'll pay good money for that advice. Billions are wasted every year on tactical allocation advice that doesn't work. To be blunt, tactical allocation is just a form of market timing, which for average investors is a losing game.

Morningstar tracks investors' tactical decisions by analyzing the flow of cash into and out of mutual fund classes. The table shows the difference in performance between mutual fund categories and investors' weighted returns in those categories--accounting for when they moved in and out. Investor returns are consistently lower, reflecting the folly of tactical allocation decisions.

A strategic asset allocation is a smarter solution because there's no loss from market guessing. Simply select fundamentally different investments for your portfolio, allocate using fixed targets and rebalance back to those targets every year regardless of what you or anyone else thinks. This method has delivered very respectable returns over the past decade.

Fund Asset Class	Fund Annual Returns	Investor Actual Returns
Intermediate-term bonds	5.5%	4.4%
U.S. equity	1.6	0.2
International equity	3.2	2.6
Real estate (REITs)	9.7	8.3

Returns over ten years through 2009.
Source: Morningstar.

Myth 3: There is an optimal strategic asset allocation.

The perfect allocation doesn't exist, at least not one that can be known in advance. Some people get hung up on such details as trying to figure out if they should have 30% in international stocks or 33%. That isn't a question anyone can answer and doesn't make any difference. What really matters in the long run is the percent you have in stocks and the percent in bonds. All else is icing on the cake.

Many investment firms promote computer models they claim can pinpoint an optimal asset allocation based on your answers to a simple questionnaire. That's as absurd as a computer dating service that picks your perfect match from your answers to ten questions.

Finding an appropriate asset allocation requires you to know your own financial and life situation and yourself. You must analyze your net worth, employment and income, saving rate, spending rate, housing situation, income you'll need from savings, when you'll need it and who is getting the remainder when you're gone. Beyond that the right allocation is the one that you can live with during a deep and prolonged bear market. It's a mix where you'll be ready to buy more stocks as stocks fall and sell stocks as they rise. It doesn't do any good to be brave and select a risky allocation that you don't have the stomach to stick with during poor market conditions.

Finally, a prudent allocation considers taxes. Some investments belong in tax-sheltered accounts, and others work well in taxable accounts. For example, tax-inefficient REITs and high-yield corporate bonds should go in a tax-sheltered account. This is all part of the process.

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Myth 4: Constant rebalancing is needed.

Not true. When you rebalance your portfolio, you sell the class (say stocks) that has grown beyond its allocation and buy the class that is below your goal. This has the added benefit of forcing you to sell when stocks may be riding too high and buy when they're cheap--without getting you involved in the losing game of market timing.

But there's no advantage to overtrading your portfolio. Annual rebalancing gets your portfolio back in line with its long-term target and gives you almost the entire benefit that more complex rebalancing methods provide. The rebalancing date could be the first of the year, your birthday, your wedding anniversary or the opening day of baseball season. It doesn't matter as long as it's consistent.

Over the past ten years a broadly diversified portfolio that included U.S. stocks, international stocks, REITs and bonds that was rebalanced annually returned one percentage point more a year, on average, than a portfolio that wasn't rebalanced. This benefit was due to high market volatility. Historically the excess return from rebalancing is lower, and at times there is no benefit. But keep doing it anyway, once a year.

Myth 5: More funds equals more diversification.

Owning more funds doesn't necessarily increase your diversification, because they could be from the same investment category and hold the same securities. In 1999 I reviewed the portfolio of an auto company executive who claimed his 401(k) was diversified because he owned ten mutual funds. Every fund he owned had an investment objective of growth, aggressive growth, capital appreciation or technology. The portfolio wasn't diversified, and he was clobbered in the 2000--02 tech wreck.

Being diversified means owning asset classes that have fundamentally different risks. These asset classes should also have expected returns that are higher than the inflation rate. U.S. stocks and U.S. government bonds have expected returns higher than inflation. The same is true for REITs and international stocks. These are good asset classes to own.

There are a few asset classes that I don't include when I allocate a portfolio because they have low returns or high costs. Commodities are a good example, because they lack the return needed to beat inflation in the long term. Hedge funds are another example. These products aren't really an asset class. They're illiquid, expensive, actively managed investment pools that you can live without.

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