SIGMA
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Knowledge plus Discipline

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Tell Me Again Why Asset Allocation Is Such A Hot Idea

Financial planners and investment advisors extol the virtues of asset allocation. "Asset allocation" is diversification among assets that have returns that are not highly correlated with one another, resulting in reduced portfolio volatility. We have written more than once in the past several months about how destructive perfectly normal human emotions can be to an investment program. Asset allocation, by reducing risk (volatility), can help reduce the impact of emotions and increase the chances of achieving your financial goals.

Many investors believe that, with the steely nerves of a riverboat gambler, they will "buy on dips" if the market gives them the gift of declining a couple days in a row.

At least that's the theory. One of the principal benefits of asset allocation should be combating investor fears of capital losses. But that fear has almost disappeared during the record-breaking run of the U.S. stock market over the past 15 years. Instead, there is a more insidious problem which is not as readily apparent. Investors are becoming too aggressive, falling into one of two groups: (1) those who have given up believing the market can decline; and (2) those who, with the steely nerves of a riverboat gambler, believe they will "buy on dips" if the market gives them the gift of declining a couple days in a row. Nobody seems to fear a bear market anymore.

As we have repeatedly written, we are not market timers and we are not predicting an imminent stock market meltdown. We are old-fashioned enough, however, to at least consider the possibility that the stock market could experience a regular, garden-variety type of decline that was common until 1982. Now that it is easy to dismiss asset allocation (since the market never goes down), our contrarian nature leads us to believe this is a good time to review its virtue. Enclosed is a chart showing the performance of four different types of assets over each of the past 31 years. The first four columns show the performance of large company stocks, small company stocks, foreign stocks and bonds. The last two columns show the performance of aggressive and balanced portfolios mixing the four assets. The best performing asset each year has a box around it.

What immediately jumps out is that the performance of large company stocks (which are in the widely-reported Dow Jones Industrial Average) is an anomaly. Prior to 1995, large company stocks were the best performer only once in 29 years. Each of small company stocks and foreign stocks were the best performer 10 times and bonds were the best 8 times. The recent run by large company stocks is unprecedented. Various theories have been put forward to explain why large company stocks should be favored (e.g. "restructuring" and "globalization"). Whatever the merits of these theories, we do not believe the dominance of large company stocks is a permanent condition. If the chart tells us anything, it is that each asset class has its season.

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At the bottom of the chart are the overall return and risk for the four asset classes and the two combination portfolios. The portfolios show quite good returns with substantially less risk than the three single equity types. We believe this shows the benefits of asset allocation -- mixing assets to get a good return with much less emotionally-destabilizing volatility. When the most widely reported asset is also the dominant recent performer, and when every radio talk-show pundit is preaching the virtues of being 100 percent invested in large company stocks, the long-term wisdom of asset allocation can get lost. Look at some of the declines (e.g. 1973-74), however, and you may wonder about the supposed steely nerves of the novice investors that have been driving the market.

Even if you believe in asset allocation, don't think you are diversified just because you invest in more than one fund in a mutual fund family. Mutual fund companies try to keep the asset allocation flame alive because they want you to be in their whole family of funds. Some will even charge you to allocate your money among their funds. Consider, however, that most fund families have a single investment philosophy and approach that permeates their various funds. We took the balanced fund, growth and income fund and growth fund of a prominent fund family and analyzed the top 40 holdings of each. Just about half the top holdings were common to all three funds. In other words, an investor could believe she was reaping the benefits of asset allocation by paying the fund family to invest money in what amounted to the same fund with three different names. You are only diversified if you really own different types of assets. This means you have to know what's "under the hood" of your investments.

Real asset allocation still makes sense, even if its significance has been obscured by the sound and fury surrounding the greatest bull market in U.S. history. When a bear market comes along, forgetful investors run the risk of getting disgusted, selling their stocks and not achieving their long term goals, unlike those who all along knew the wisdom of diversification. While it might not give you bragging rights at the water cooler, if designing a long term rational investment plan makes sense to you, contact us.