

Multiple Style Combinations

A Way to Use Asset Allocation

Multiple Style Combinations begins with asset allocation, and the principle of diversification. The idea is that by diversifying, you can both increase your chances for returns, AND lower the expected volatility.

Asset allocation is the core strategy for building and managing each investment portfolio. You allocate your assets by deciding how much to invest in different asset classes, or investment categories. For example, you might invest some in stocks, some in bonds, and some in cash or cash equivalents. Because different asset classes typically react differently to changes in the financial markets and to broader economic conditions, a well-diversified asset allocation will be the crucial element in implementing your investment strategy. For example, a market that produces strong stock returns may cause bond returns to slump, and vice versa. But, if you spread your investments across different asset classes, you may be able to limit, or offset, potential losses in one asset class with stable values, or even gains, in another. The key to successful asset allocation is well-developed investment objectives.

The general consensus among investment principles is that the asset allocation decision accounts for more than 80% of the total return of the portfolio. Some professional analysts even suggest that the asset allocation decision accounts for more than 100% of a portfolio's performance (which does not say much about an individual manager's value added). Nonetheless, this decision is the most crucial in the investment strategy process. An acceptable style allocation cannot be made without the proper asset allocation. Suffice it to say that 100% in stocks is not for everybody. The risk/reward balancing act we have discussed previously is never more apparent than in this recommendation.

Unfortunately, the primary basis we have for making an asset allocation decision is based upon our understanding of the historical behavior of the Capital Markets by using historical performance. As we have already pointed out, historical performance is an unreliable predictor of future performance and past performance, of course, is no guarantee of future performance. Still, it's the best we have to work with. We have an entire course devoted to asset allocation.

Suffice it to say that while no one investment strategy is right for all investors, most investors will benefit from a strategy that includes combinations of components. A mixture of large and small capitalization growth and value stocks with some bonds, and a sprinkling of, say, international, MAY produce an approach that fits your investment objectives. Similarly a healthy mixture of mutual funds, ETFs and one or more separately managed accounts (depending on the amount of assets available for investment) may help you achieve your goals.

Capital Markets Behavior Helps Determine Asset Allocation

With the investment objectives set and policy developed, the science of capital market modeling can proceed. The Capital markets are like a Venetian blind or yo-yo; they go up and they also go down. Modeling helps find the mix of assets that provides an acceptable probability of achieving the objectives with a tolerable level of risk, at any point in time. But like the Capital Markets, asset allocation is not a static. It is dynamic and needs fine tuning and adjustments along the way--all the while staying within your investment objectives and goals (no knee-jerk reactions to sudden market events.) Remember, the tradeoff here is that the pursuit of higher returns is generally associated with higher risks. One important offset to this relationship is diversification. Proper diversification can actually increase expected return and reduce risk.

Listed below are investment results for the full 75-year history from 1926 to 2000 for large stocks, long-term corporate bonds, and short-term investments. It represents a typical example of the interrelationship among the various capital markets.

Since 1926 stocks have produced an average of almost 7.9% in annual return. The range of annual returns for stocks for that time period were from +78% to -53%. Long-term corporate bonds averaged 6% with the biggest down year -19%. Short-term treasuries 3.8% with no down years (the risk free proxy). The problem is that returns are dramatically reduced when you factor in taxes and inflation.

The History of Inflation

Inflation erodes investment gains, having reduced returns by an average of 3% per year since 1926. In the 1970s, inflation reached a pace unprecedented since the 1940s, peaking at 13.3% in 1979. The average rate of inflation during the '90s was 2.71%. A dollar at the end of 2010 was worth just 70% of its value at the close of 2000.

When market performance is adjusted for inflation through December 31, 2010, a dollar investment in stocks made in 1926 was worth \$340, representing less than a 5% real return. What is significant is that annualized stock returns have not increased since 2000, and the practitioners' predictions do not hold that long-term results will stray much above that. In other words, while we may have occasional years of better returns, (and some lower), the long-term projection is an annualized average around 6%.

The History of Market Opportunities

Market timing is the shifting in and out of stock and bond markets when the money manager feels that it is the right time. Market timers are also called active asset allocators. While there are many different specific strategies associated with market timing, we will only look at the concept here.

There is no conclusive proof that market timing works but timing of investment matters. In theory, if someone had a foolproof system for timing the market, they should have all the money to manage. The risk of market timing is the risk of being wrong. This can have two effects: investors could miss a market opportunity by being "Out" of the market during a positive move, and they could be in the market during very volatile down periods. Actively managed accounts provide an alternative for your clients' core assets, but the risks associated with trying to time the market precisely are dangerous. Consider the following data:

In the ten years ending December 1998, stocks earned 19.2% per year. If an investor had missed the best six months of those 10 years (5% of the total number of months), the annualized return would have slipped to 13.2%. It is not possible to outsmart the market. There is too much public knowledge available, and tens of thousands of professional analysts pouring over new data every day. Even the professionals have difficulty doing it.

But timing matters, not that you can do anything about it. Consider an investment in mutual funds. As we have seen markets go up and down daily. The day you choose to invest in that fund may be the all time high for the year. You can only go down from there. A luckier investor may buy the same fund a month later when it was at it's yearly low. By year end, they're up; you're down in the same fund. The same example applies to a stock, bond or commodity. Timing matters. Still all the technical analysis in the world won't help you much. A wise person once said, for every seller of a security, there is a buyer of that same security at the same time. That is the nature of a market--buyers and sellers. Can they both be right?

Asset Class Behavior

Each of the traditional asset classes tends to produce its strongest returns under different market conditions than the other asset classes do. For example, stocks often shine when corporate earnings are strong and financial markets are growing. Yet this same environment frequently has the opposite effect on bonds, so that they provide lower than average returns. On the other hand, bond returns often rise in a period when stock values drop. That may happen when interest rates go up or when corporate earnings don't meet investor expectations. If you have your assets appropriately diversified among various asset classes, you can benefit from offsetting down-market performers with those that generally move in the opposite direction.