Registered Rep. Investing

KILL THE TWO-ASSET MODEL

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Too many advisors are still stuck doing 60/40 asset allocation plans. Try five asset classes instead.

Like you, I was sitting in my office in fourth quarter of 2008 looking for a safe place from the earthquake of bad news that was pummeling the capital markets. Like you, I was surprised that even my most conservative portfolio — stocked with judicious and sensible mixes of investment grade bonds, large-cap blue-chip stocks and cash — was getting crushed.

And, like you (probably), I decided to do something different from now on so that 2008 would be less likely to repeat itself. That something is not to focus on any one asset class, or two — you know, the old 60/30/10 stocks/bonds/cash mix, or one of its iterations. Instead, I am diversifying among several asset classes, the way that most institutions do. If you try to rush your way out of this mess by focusing your clients' assets on any one make-it-back-quick fix (think investments in undeveloped land, emerging markets, international bonds, cap-and-trade ETFs, or whatever), then you will soon deliver them another 2008. My only regret is that it has taken me 25 years to figure this out.

Let me frame my argument with a true story. (You could likely tell the same story about a few of your clients.) The other day a sophisticated long-time client said something that shocked me. This client is 61 years old, has been actively investing for over 30 years in stocks and real estate, has almost $2 million in investable assets and is a principal of a major commercial real estate investment firm. We were talking about his 401(k) that I manage, and he told me that the best investment he has ever made was … a whole life insurance policy. That's right, a whole life policy. I never thought I would hear that one. No, I am not going to start selling whole life policies, but I am going to position my clients in the future so that a relatively low fixed rate of return (as is found in whole life policies) will not be the best investment my clients can make. I guess you could say I have a new benchmark — the returns on a whole life policy.

THE BENEFITS OF DIVERSIFICATION

	1 Asset*	2 Assets**	5 Assets ***
10 year return	-1.38%	1.31%	5.98%
15 year return	6.45%	6.83%	7.48%
Worst 3 year return (of 15)	-16.09%	-6.61%	-4.15%
Beta	1	0.67	0.39

*1 Asset = Stocks; **2 Assets = 65% Stocks, 35% Bonds; ***5 Assets = 20% each Stocks, Bonds, Cash, Real Estate, Commodities
Stocks: S&P 500; Bonds: Bar Cap US Long Cdt A; Cash: Fidelity Cash Res; Real Estate: DJUS RE; Commodities: Morningstar Long-Only Comm.
Source: *Martin Metrics. Annualized returns through 12/31/08 with annual rebalancing. Morningstar Advisor Workstation.*

So what do you need to do differently? If you want to protect your clients from another lost decade you need to re-think the standard asset allocation model that is the root of modern portfolio theory. There has been much written about this recently, including in this magazine, too. (See the July and August cover stories.) The MPT model says that the ideally diversified portfolio lies somewhere along the stocks/bonds/cash continuum, and varies only by investor age and risk tolerance. The securitized proxy of the model is often a balanced fund of roughly 60 percent stocks and 40 percent bonds; many asset allocation programs are based on some adaptation of this. I have a wall of shame in my office that lists 13 major money managers and publications, all of whom you and your clients know, that perpetuate this two-asset model and do so even after the collapse of last year. They are telling the world that there were no lessons to be learned in 2008.

ASSETS GALORE

This will not do. If nothing else, 2008 taught us that there are more investment choices in the world than just stocks and bonds. Investable assets can be broken down into at least five (not two — or three if you count cash) nominal categories: stocks, bonds, cash, real estate, and

commodities. You will be tempted to add derivatives, currencies, options or some other esoterica to this list — but don't. The industry is making a big mistake by jumping from too simple a model (i.e., 60 percent stocks/40 percent bonds) to too-complicated a model (i.e., Micro Cap 3x Inverse Leveraged Short Singapore ETF). That's not the answer.

DIVERSIFICATION LEADS TO BETTER INVESTOR RESULTS

	10 Year Investor Return	10 Year Total Return	Success Ratio
Equity Sector Funds (100% tech, health, etc.)	6.75%	9.53%	71%
Balanced Funds (inc. Target Maturity funds)	7.88%	7.80%	101%

Asset weighted averages, 10 years ending 12/31/2007 — Source: *Morningstar, Inc.*

One solution is to invest in the five asset classes in equal proportion and leave it alone. Sounds pretty simple and it is. How has a portfolio with such an allocation performed? The accompanying charts compare the returns of stocks, a traditional balanced fund and a diversified portfolio of stocks, bonds, cash, real estate and commodities for ten and fifteen years through 12/31/08. You can leave the asset allocation alone, or, if you must, you can tinker with asset allocation in an effort to add alpha. Here, buy and hold is fine (rebalancing annually) and it works, because we have a portfolio that is worth holding.

As we add assets, we create a fully diversified portfolio with greater returns and lower risk — every investor's objective — no, dream. Basically, all we have done is expand the concept of a balanced fund and evolved it into the 21st century. Each client that I have shown this to has gotten it instantly, and most want to make the switch immediately.

Disclaimer: Just because a well diversified portfolio outperformed for the last 10 and 15 years does not mean that there is any certainty that this will continue (of course). One interesting fact is that though the diversified portfolio outperformed the stock portfolio overall and did so with significantly less risk, for most of the 15 year period, stocks outperformed the diversified portfolio. Why? From 1993 to 2000, the value of stocks nearly quadrupled. Therefore, the diversified portfolio doesn't work for each time period; it just tends to perform well long term and with lower volatility.

And in fairness to traditional two-asset balanced funds (a truly ingenious, albeit faded model), at least they are not single-asset portfolios with 100 percent allocations to stocks, where investors almost automatically under perform on a risk-adjusted basis.

RESULTS DIFFER BETWEEN ASSET CLASSES

Fund Group by Asset Class	Investor Return	Total Return	IR-TR Gap
U.S. Diversified Funds	6.03	730	-1.27
U.S. Sector Funds	6.75	9.53	-2.78
Balanced Funds	7.88	7.80	0.08
Intl. Diversified Funds	10.83	11.29	-0.46
Intl. Regional Funds	10.60	11.38	-0.78
Western Asset	5.13	5.47	-0.34
Taxable Bond Funds	4.29	4.45	-0.16
All Funds	6.59	7.49	-0.90

Asset weighted averages, 10 years ending 12/31/2007 — Source: *Morningstar, Inc.*

Morningstar has produced interesting research that compares total return to investor return between “Equity Sector Funds” and “Balanced Funds.” They call this comparison the “Success Ratio.” The study showed that though equity sector funds outpaced balanced funds (9.53 percent vs. 7.80 percent) for the 10 years ended 12/31/07, investor returns were higher for balanced funds than equity sector funds (7.88 percent vs. 6.75 percent). Among every fund group measured, balanced fund investors were able to pull the most out of their investment. This may be because lower relative volatility gave balanced fund investors a smoother ride, so they were more willing to stick it out.

Balanced fund investors tend to stay the course longer and stand a little taller at the finish line. However, after last year, most would say that they are ready for fewer hills and faster times. If so, diversification may be the answer.

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