Asset Allocation

It's not your father's '100 less your age rule' anymore!

"We believe that active management focused on fundamental research and bottom-up security selection applied by properly motivated teams of skilled and experienced people will add value over time.

Research has shown that asset allocation is the single most important factor in determining long term investment results. The historical returns of US stocks and bonds have averaged approximately 10% and 5%, respectively, so the mix of these two major asset classes obviously will have a major impact on realized returns. In order to manage both the inherently higher risk associated with equities and to provide a stream of current income, a common rule of thumb used for many years to determine one's allocation to equities was to subtract one's age from 100. For example, a 40 year old would have 60% allocated to equities and 40 % allocated to bonds. The theory behind this "rule" was that a younger person had the time to recover from a stock market downturn, and generally did not have a need for as much current income from their portfolio as compared to someone who was retired.

Given longer life expectancy and the much more active lifestyles of today's retirees, this rule is overly simplistic to be of much value. Additionally, no rule exists that fits all circumstances, and one's investment objectives and risk tolerance must be carefully considered when setting forth an investment plan. For example, a very wealthy individual (e.g. a liquid net worth in excess of $20 million) has the option of allocating a larger percentage to higher risk and potentially higher return assets and still maintain a sizeable "cushion" of very low risk assets (money market, Municipal bonds, etc.), or this individual could choose to take a totally different tact and place their funds in low risk (and lower return) assets given that their financial goals have probably been reached.

At the opposite end of the spectrum are individuals who are facing near term capital needs (purchasing a home, funding college expenses, etc), or who do not have the time frame required to be heavily invested in equities. Our firm recommends that one should have an investment horizon of a minimum of three, and preferably five, years in order to invest in equities given the near term volatility of stocks. Also, it is critical to factor in the "sleep at night" consideration. Many people are simply not comfortable experiencing losses from their investments as evidenced by behavioral finance studies which conclude that the pain of losing money is nearly three times greater than the joy of making money!

However, for the vast majority of investors planning for retirement, exposure to stocks should be considered. Given the superior historical returns generated by stocks versus other financial assets, equities, when held for the long term, provide the best protection against inflation. After evaluating current liquidity needs, life expectancy, and one's own personal risk tolerance, a portfolio appropriate for each investor can then be constructed.

Once the asset allocation has been determined, one must decide in which investment styles to invest. Here the key issues are diversification, return and risk expectations, management costs and taxes. While Wall Street has an inexhaustible ability to create new investment products, for most investors the key to success is to "keep it simple". A well diversified core US equity investment strategy comprised of a variety of market capitalization stocks, fixed income (municipal bonds in taxable accounts is usually preferable), and possibly an international equity strategy (for 10 - 15% of the equity allocation) is all that is required to create an overall portfolio with solid return expectations and appropriate risk levels. For larger portfolios, alternative investments such as hedge funds and private equity funds will further diversify your holdings, but these investments typically have very high minimums and liquidity restrictions which make them less suitable for most investors.

In addition to the asset allocation and style decisions, one must determine the most tax-efficient way to implement the plan. This often involves making decisions as to how best divide each asset type between one's taxable and tax-deferred portfolios. Since you only have access to your after-tax return, optimizing an investment plan's tax efficiency is essential.

Now that your funds are invested, the monitoring and the periodic rebalancing of your investments are critical to investment success. If there are significant changes in the management team of your selected funds, or if the investment style moves away from the original objective, one should consider making a change. The rebalancing of your portfolio should take place no more than once per quarter, and normally an annual rebalancing is adequate. The objective is to sell those funds which have now appreciated beyond your long term target, and to purchase those funds which have underperformed in order to increase your holdings of those investments up to the long term asset allocation target. Over time this process helps to smooth out the price fluctuations of your portfolio and normally provides attractive risk adjusted returns.

In conclusion, long term investment success requires developing and adhering to a disciplined plan that meets your investment objectives and comfort level. By setting up an approach as described above, you can step back from the day to day emotion of the market and allow your portfolio to compound over time and enjoy a vibrant and well deserved retirement.

Vaughan Nelson Investment Management