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Develop Business/Managed Money

## Radical Thoughts on Asset Allocation

By Elaine Floyd, CFP

**Every so often it can be enlightening to read some contrarian thinking—particularly about an investment strategy that has so thoroughly pervaded the industry.**

Asset allocation has been standard operating procedure among financial planners for more than 10 years now. Although it is based on the work of economist Harry Markowitz, whose paper "[Portfolio Selection](#)" was published in the *Journal of Finance* in 1952 and formed the basis of modern portfolio theory, it was not until the 1990s that the concept really took off.

The pivotal study that unleashed the trend was published in the July/August 1986 issue of the *Financial Analysts Journal*. In "[Determinants of Portfolio Performance](#)," Gary Brinson and colleagues concluded that 93.6% of portfolio returns can be explained by asset allocation policy, or so advisors believed. With such strong evidence supporting asset allocation, advisors could now use a scientific but relatively simple approach to designing client portfolios: just allocate assets to stocks, bonds, and cash based on the investor's risk tolerance and time horizon, and the job is virtually done.

It almost didn't matter which stocks and bonds were chosen—or which mutual funds or separate account managers were selected to implement the policy—because most of the heavy lifting had already been done through the simple allocation of assets to the major asset classes. The only follow-up work required was to periodically rebalance portfolios to restore the original allocations following market movements and to occasionally move assets based on changing client objectives, primarily shortened time horizons.

This interpretation of the Brinson study promised to relieve advisors and investors from the arduous task of forecasting the market or figuring out which sectors or stocks might have a better chance of outperforming the rest. All they had to do was stick with the asset allocation policy, ignore the noise of the market, and have faith. After all, individual security selection played a nearly negligible role in determining investment returns, according to Brinson and colleagues.

Then asset allocation theory collided with reality. Where advisors used asset allocation as a way to diversify client portfolios, clients who were now watching the market and their own statements thought asset allocation meant (or should mean) concentrating the portfolio in the asset class that was doing the best—or, during bear markets, avoiding asset classes that were not doing well. In other words, the concept of asset allocation was embraced by all, but advisors and clients each had a different take on it.

Is it time to abandon the notion of strategic asset allocation? Some people think it needs to be tweaked. Here are some radical ideas being tossed around in academic and media circles that may diminish the dominance of asset allocation.

## The interpretation is flawed

What many advisors failed to note is that the the Brinson study only explained the *variation* in returns, not the returns themselves. And critics took issue with other conclusions. William W. Jahnke, an advisor, wrote "[The Asset Allocation Hoax](#)," which appeared in the February 1997 issue of the *Journal of Financial Planning* (and was reprinted in the August 2004 issue). Jahnke delves into several statistical issues, one of which is the focus on variations in quarterly returns rather than total returns over the 10-year period covered by the study. In fact, he says that if you look at returns over the 10-year period, asset allocation explains only 14.6% of the range of actual portfolio returns—not 93.6%.

But the bigger issue seems to be the fact that the Brinson study did not analyze the decision-making process used to determine asset allocation policy. What is a good asset allocation policy, anyway? Anyone doing it had better know, especially if he or she believes that it explains 93.6% of a portfolio's returns. But the study did not reveal whether a good asset allocation policy is based on diversification or concentration.

For that, advisors looked to Markowitz, who finally landed the 1990 Nobel Memorial Prize for Economic Science with his colleague William Sharp for their theories on diversification. But clients, who had never heard of modern portfolio theory—or whose eyes glazed over when it was explained to them—simply based their theories on how much money they were making—or could have been making had their portfolio been concentrated in the best-performing asset classes rather than spread all over the map.

This raises the question of how long an asset allocation policy should remain in effect. Jahnke says that the idea that a pension plan or individual investor should set long-term fixed asset class weights is flawed. Only if expected returns are fixed should asset allocation weights be fixed. In fact, he says, investment opportunities change over time, both absolutely and relatively. For this reason, Jahnke says that asset allocation should be viewed as a dynamic process, taking into account both pension obligations (or, in the case of individual investors, investment goals) and capital market opportunities, including risk. As investor goals and investment opportunities change, asset allocations should also change.

And the widely used practice of basing allocations on historical returns has also got to go, according to Jahnke. He says historical returns are not only unreliable indicators of future returns, they are often perverse indicators. Historical returns are the highest at market tops, which means those who rely on them to set asset allocation policy are subject to buying high and selling low.

For a further debunking of the Brinson study, see "[Asset Allocation, Part 2: Common Myths](#)." Also see other articles by William Jahnke in the *Journal for Financial Planning*, especially "[It's Time to Dump Static Asset Allocation](#)" in the June 2004 issue.

## Individual securities matter more than asset class

In a direct contradiction to the Brinson study, James B. Cloonan, chairman of the American Association of Individual Investors (AAII), has this to say when someone advocates putting a certain percentage in bonds or stocks: "Which bonds, which stocks?" He says that if he's considering a portfolio that is 70% invested in an S&P 500 index fund and 30% in a bond fund,

he can always find a 100% stock portfolio that carries less risk and a 100% bond portfolio that carries more risk. What matters more are the individual securities within the asset class. He advocates choosing individual investments first and allocating weightings later.

Here are some of the problems with the usual approach to asset allocation, according to Cloonan:

- The [correlation](#) between stocks and bonds changes all the time—over the past 70 years the correlations have run from -0.3 to +0.6. How can you have an asset allocation plan that does not adjust for these differences?
- [Diversifying](#) between value and growth stocks is hard to do when, according to his estimation, only 15% of all stocks are true value and 15% are true growth; what do you call the rest of them?
- An [S&P 500 index fund](#) will have 23% of its assets invested in the largest 10 stocks; not only is this too much concentration, but the largest stocks often have high correlations.

This would appear to be an argument in favor of active management. Think about it: if you have three clients, each with a 60/40 split between stocks and bonds, and you put one with the best-performing managers, one with the worst-performing managers, and one in index funds, their returns will be vastly different, even though the asset allocation for each portfolio is the same. How can it be declared that asset allocation is responsible for 93.6% of a portfolio's returns when three clients with the same allocations can have such widely varying results?

## Diversification dilutes returns

Warren Buffett, in managing the investments of Berkshire Hathaway Corp., doesn't care about asset allocation. If he finds a company or a stock he likes, he buys it. And he buys a lot of it. Robert Hagstrom Jr., author of [The Warren Buffett Way](#), says Buffett believes investors are better served if they concentrate on locating a few spectacular investments rather than jumping from one mediocre idea to another. If, over his career, you eliminate one dozen of Buffett's best decisions, his investment performance would be no better than average.

Buffett says investors should act as if they had a lifetime decision card with just 20 punches on it. With every investment decision, the card is punched, leaving one fewer available for the rest of the person's life. If investors were restrained in this way, Buffett figures that they would wait patiently until a great investment opportunity surfaced.

Maybe it's time to rethink the whole concept of asset allocation. Specifically consider:

- **Asset classes vs. individual investments.** Is it necessarily better to go from the top down instead of the bottom up?
- **Which asset classes should you use?** The Brinson study considered only stocks, long-term government bonds, and T-bills. But many asset allocation plans break these down into many subcategories. How many asset categories are appropriate?
- **Strategic vs. tactical.** How long should an asset allocation plan be [left in place](#)? What criteria should you use you to change it?

- **Historical returns vs. forecast modeling.** Should you look to the past or the future when considering risk-adjusted returns of the various assets?
- **Diversification vs. concentration.** Is it always better to diversify? Why? Should your diversification/concentration policy be static or should it vary based on economic and market conditions?

**For further reading:**

["The Asset Allocation Myth,"](#) David B. Loeper, CIMA, Financeware

["Does Asset Allocation Policy Explain 40, 90, or 100% of Performance?"](#) Roger G. Ibbotson and Paul D. Kaplan, Ibbotson Associates

["Investment Policy Explains All,"](#) Ron Surz, Dale Stevens, and Mark Wimer, PPCA

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