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THE FIVE ESSENTIALS

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CHAPTER 1

The First Essential: Determine the Right Asset Allocation

Now let's turn to improving your investing skills.

Chapters 1 and 2 are the most important in this book. To give you an idea how important they are, over 2,500 books and countless magazine and newspaper articles have been written on the subject of how to spread your money among—and within—classes of assets.

Given its fundamental nature you would think that virtually every investor would be well acquainted with the principles of diversification. Yet I find that such is not the case. I continually run across investors who have only the haziest idea of how to correctly implement an asset allocation and diversification strategy. I use a quick test to gauge their competency in this area:

Question: Do you know what percentage of your portfolio is currently invested in equities? Yes, no, without looking it up? If you don't carry that number in your head, you may not be applying whatever you do know correctly.

There is a tendency to ignore diversification, perhaps because it is so basic. And a fair number invest with the belief that they already know it all. But that's not usually the case. So let's start at the beginning.

The Basics

Asset allocation basically means holding various asset classes whose performance is uncorrelated; that is, they fluctuate independently

of each other. That's the whole point. If two investments fluctuate in tandem, they won't provide diversification, or reduce risk.

The three most important asset classes for individuals are: stocks, bonds, and cash. At the institutional level there are many more. For convenience's sake, I'm going to call these classes of assets *baskets*.

The following statistical table shows that there is virtually no correlation among the three basic baskets. Zero is no correlation; 1.00 and -1.00 are perfect positive and negative correlations. This is critical. You want zero correlation, or better yet, negative correlation. If two asset classes have a high positive correlation, then they are really variations of the same asset class, and don't increase diversification.

Asset Class	Correlation
World equity vs. U.S. investment-grade bonds	0.15
World equity vs. cash and cash equivalents*	-0.02
U.S. investment-grade bonds vs. cash and cash equivalents	0.03

*Short-term investments, such as short-term bonds.

Source: Capital Guardian, Sept. 17, 2010, presentation to Westchester Community College Finance Committee

Now you see why spreading your money among stocks, bonds, and cash gives you superior diversification and risk control. You are always at risk no matter what you do, but with this approach you have dramatically reduced the likelihood that all your investments decline at once. How you allocate these baskets in your portfolio can determine up to 90 percent of your returns. This alone tells you where you should be spending your investing time.

If you own your own business, though, diversification may not be an option. You will probably have all your money in it. But that's not the case when you invest in other people's businesses—that's what you do when you buy listed stocks. There you may have the choice of diversification or concentrated investing. Some people follow the concentrated path in investing—and some of these people become very, very wealthy. But in all likelihood, you will never know enough about the workings of publicly traded companies, or how the actions of other investors will impact your holdings, to be comfortable putting all your money in one, or even a few, stocks. This also applies to investing in companies you work for, if they are large enough to have publicly traded stock. Let me be

very specific: *Diversification is not about maximizing profits; it's about reducing risk.* And there is no better way to reduce risk. It's not just for individuals, either. Many hedge fund and mutual fund pros have dispensed with diversification and come to grief because it is impossible to be expert in every holding. Expert or layman, when bad things happen there is really no protection other than diversification.

Diversification is not about maximizing profits; it's about reducing risk.

I think one of the reasons the *Investor* newsletter led the nation in risk-adjusted returns for so many years (we were number one among all newsletters for the 20 years ending June 2008) is because we had the best asset allocation. We were one of the few newsletters that routinely allocated part of our model portfolios to bonds. Most newsletter portfolios recommend stocks only, or even higher risk securities such as options.

Learn from the Big Boys

Even though you may never be an institutional player, it's useful to know what the big boys do. Here's a comprehensive allocation developed by David Swensen, who manages Yale's multibillion dollar endowment. He suggests six baskets with no asset class greater than 30 percent, or less than 5 percent:

- | | |
|--|-----|
| 1. Domestic stocks: | 30% |
| 2. Foreign stocks: | 15% |
| 3. Emerging-market stocks: | 5% |
| 4. Real estate: | 20% |
| 5. Treasury bonds: | 15% |
| 6. Treasury inflation-protected securities (TIPS): | 15% |

For individuals with substantial assets this allocation makes a great deal of sense.

Another asset class to consider is commodities, which are much simpler to invest in nowadays with the advent of sector exchange-traded funds (ETFs).

How the Ancients Allocated Their Wealth

Many contemporary investing strategies such as random walk, modern portfolio theory, index funds, and even growth stock investing

were developed after World War II and are relatively new. But asset allocation is not new. It's been around as long as people have had wealth.

The oldest recorded asset allocation advice may be from biblical times. The *Talmud*, a record of rabbinic discussions pertaining to Jewish law, ethics, customs, and history (circa 1200 B.C.–A.D. 500) recommends: “Let every man divide his money into three parts, and invest a third in *land*, a third in *business*, and let him keep a third in *reserve*.” Today we would call these three baskets real estate, common stocks, and money funds. You can clearly prosper with that advice right now.

Jumping to more recent history, the fabled Rothschild family had an asset allocation formula that worked well for over a century and, amazingly, remains totally relevant today. The Rothschilds placed one-third of their wealth in each of three baskets: *securities*, *real estate*, and *art*.

It's interesting that both historic examples allocated wealth into three baskets and that's basically what most individuals do today, except that our baskets are slightly different. Today, we categorize the baskets as stocks, bonds, and cash, but the principle of three endures as a sound minimum.

And here's another historic example of diversification. In Shakespeare's *Merchant of Venice*, Antonio declares, “My ventures are not in one bottom trusted.”

And, of course, that's what insurance is all about—spreading the risk through diversification. Lloyds of London was founded around 1688 to insure shipping, so a shipper could put all his cargo in “one bottom.”

It's not known when American investors began to allocate their assets to both stocks and bonds, but the first balanced fund, Vanguard Wellington, was launched in 1929. Vanguard Wellington utilized a 60/40 distribution (stocks to bonds), which is still basic today.

Of course, we are more sophisticated now and at the institutional level, some large portfolios have as many as eleven baskets. That's too much for most individuals, but you can certainly consider commodities, timber, foreign bonds, inflation protected bonds, gold, real estate, art, collectibles such as fine wines, rare books, classic cars, jewelry, and memorabilia. Still, the “big three” are all you absolutely need.

Your Most Important Task: Determining the Best Asset Allocation for You

First of all, there is no single “right” allocation. It’s essential to choose an allocation that works for you, considers your current holdings and, most importantly, takes into account a long-term market forecast and your personal risk profile, which depends on your financial ability to tolerate risk, and your willingness to do so.

Regardless of what you choose, the important thing is to *know* your target asset allocation and either stick reasonably close to it, or have logical reasons for not doing so.

There is no single “right” allocation.

Here are some of the factors you need to consider to reach your own personal allocation:

- How many *years* before you need the money, either for retirement or for other purposes such as college?
- How long does the *money have to last* in retirement? An estimate is helpful.
- How easily can market losses be *replaced*?
- How much *inflation protection* do you need?
- *Age*: Generally older people should take less risk, but there are some significant exceptions. For most people age is closely linked to the time horizon.

These factors are really all facets of what is called your *time horizon*. For most people that’s the bottom line. In addition consider:

- *Wealth* (more important than most realize): It’s dangerous to take substantial equity risks if you don’t have a cushion.
- *Family*: How solid is your marriage? What child rearing expenses are you likely to incur (including college costs, and possible wedding expenses)?
- Are there any circumstances under which you would wind up being financially responsible for any other members of your family? Have you ever co-signed a loan?
- *Income* (if you are still working; or cash flow if you are not): How great is it? How stable is it? The more you have, the easier it is to accept risk.
- How much to set aside for *emergencies*?

- How much money do you want to set aside for *charities*?
- *Equity market outlook*: Are you long-term bullish or bearish?
- Are your stocks or equity funds more or less *risky* than the market?
- How much are you *willing to lose* without cutting your losses?
- How much *volatility* can you accept?
- What is your *current allocation*, and how happy are you with it?
- How closely are your earnings *linked to the stock market*? If you are an investment professional, or work for an investment professional, putting your personal wealth in the market can leave you dangerously undiversified.

Putting all these factors together for optimum results is no small job. I suggest some specific model portfolios lay on; however here's a shortcut for people who want to do it themselves. Go to the Vanguard "Personal Investors" website and, using the "What are you looking for?" search box, type in "investor questionnaire." Answer the questions and submit. The program will suggest an allocation that might work for you:

Vanguard Investor Questionnaire (summary of multiple-choice answers in italics)¹

1. When making a long-term investment, I plan to hold the investment for: (*# years*),
2. From September 2008 through November 2008, stocks lost over 31 percent. If I owned a stock investment that lost about 31 percent in 3 months, I would: (If you owned stocks during this period, select the answer that corresponds to your actual behavior.) (*sell, hold, buy*)
3. Generally, I prefer investments with little or no fluctuation in value, and I'm willing to accept the lower return associated with these investments. (*agree/disagree*)
4. During market declines, I tend to sell portions of my riskier assets and invest the money in safer assets. (*agree/disagree*)
5. I would invest in a mutual fund based solely on a brief conversation with a friend, co-worker, or relative. (*agree/disagree*)
6. From September 2008 through October 2008, bonds lost nearly 4 percent. If I owned a bond investment that lost almost

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- 4 percent in 2 months, I would: (If you owned bonds during this period, select the answer that corresponds to your actual behavior.) (*sell, hold, buy*)
7. The following chart shows the greatest one-year loss and the highest one-year gain on three different hypothetical investments of \$10,000. Given the potential gain or loss in any one year, I would invest my money in: (*low-, medium-, high-volatility investments*)
 8. My current and future income sources (for example, salary, Social Security, pension) are: (*unstable/stable*)
 9. My previous investment experience and satisfaction with the following six asset classes are: (*See website for list.*)
 10. The information you enter in the following grid will determine your time horizon (how long you plan to hold your investments). Your current allocation is: (*percent stocks, bonds, cash*)

I keep my personal asset allocation on a spreadsheet, and recommend you do so, too. It can be updated any time by just punching in a few closing prices, which you can get online. It doesn't take any time at all. I do mine in less than five minutes. If you are not computer-literate, use a calculator. Check your allocations regularly. This discipline is far more important than keeping track of your favorite stock or fund.

Also, by including cash in a spreadsheet, you are able to take personal spending into account. I suggest benchmarking total financial assets to the previous December 31, so you know at all times if you are spending more than you are making and appreciating.

For an in-depth professional look at asset allocation, read the second edition of *The Art of Asset Allocation* by David M. Darst (McGraw-Hill, 2008). Darst is a managing director at Morgan Stanley. Another good book on the subject is *All About Asset Allocation* by Richard A. Ferri, CFA (McGraw-Hill, 2006).

Important Lessons in This Chapter

- There is nothing more important than asset allocation. Do it first, and check it the most often. Change it when necessary. Your asset allocation should be foremost in your mind at all times.
- Above all, when you get your asset allocation right, you'll be around to invest another day. See Chapters 3 and 7 for specific advice.

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