



Step 2: The Enduring Importance of Asset Allocation

Our first report discussed the importance of developing an investment philosophy. The next step is allocating your portfolio between stocks, bonds, and other assets. How do you balance risk and return in a way that gives you a reasonable chance of achieving your goals and that still allows you to sleep well at night? There is ample evidence that the asset allocation step is the most important portfolio decision you will make and is well worth the time and effort to understand the process and get it right. Diversification is the key. The critical first step in the diversification process is the asset mix, discussed here. The second step deals with security selection within the asset classes, covered in our next report.

A portfolio's performance depends on the interrelated decisions of asset allocation, security selection, and market timing. If you could precisely choose the most opportune time to be invested in only the most rewarding asset class, then market timing would be far and away the most important of these variables. There are no shortage of investment gurus, some professional and some simply charlatan, that will take you down the market timing path for, of course, a generous fee. Overwhelmingly, the evidence indicates you would be wasting your money.

The Evidence

Several independent studies have addressed the relative importance of asset allocation versus other possible sources of portfolio return. Most quoted is the Brinson, Hood and Beebower study "Determinants of Portfolio Performance", first published in 1986, which found that the primary driver of a portfolio's return is asset allocation, with security selection and market-timing playing lesser roles.ⁱ Brinson et al. found that asset allocation alone accounted for 93.6% of the quarterly variation of broadly diversified pension fund returns. In the context of a broadly diversified portfolio, the decision to invest in common stocks as an asset class was far more important to long-term returns than which stocks were actually owned. In a follow-up study in 2000, Ibbotson and Kaplan researched the performance history of balanced mutual funds and found that 81.4% of the monthly variation in returns was due to asset allocation.ⁱⁱ In 2003, the Vanguard Group looked at 40 years of monthly return data for 420 balanced mutual funds and found that 76.6% of a fund's returns were attributed to its asset allocation policy.ⁱⁱⁱ These results held up in all time periods and all investment environments, bull market or bear.

Dalbar, a Boston research firm, performs an annual survey of actual investor returns in mutual funds and compares them to the return of the overall stock market. Over the twenty year period ending in December 2012, the average return of all investors in U.S.

stock mutual funds was 4.25% annualized per year. Over the same time period, the S&P 500 returned 8.21% per year, or almost 4% points more. A \$10,000 investment at 4.25% would be worth \$22,989 twenty years later, while the same investment compounded at 8.21% would be worth more than twice as much, or \$48,546.^{iv}

There are many reasons why investors usually trail the market. After fees and expenses, the average mutual fund trails the market, a fact confirmed by numerous studies. But the Dalbar studies also indicate that a big part of the reason is also investor behavior. Investing is an emotional process that often produces irrational decisions to move money in and out of the market at the wrong time. The cost of those decisions is significant.

The evidence is clear that asset allocation is the most important choice investors make and should be the first priority in setting up an investment plan. Investors should choose a mix of stocks, bonds, and other assets that is consistent with their financial objectives and risk tolerances, and then change that allocation only when their objectives change. Attempting to change basic allocations based on market predictions (i.e., market timing) is generally an unproductive and expensive exercise due to the additional costs associated with more trading, higher management fees, higher taxes, and bad timing. The opportunity costs of being out of the market, as noted in our first report, can also be devastating to long-term investment returns.

The Process

The first step is to ask, “How much money will I need during my life, and what do I want to do with my money when I am gone?” Here is a three step process:

Setting Goals

How much you will need in a retirement nest egg, your particular “number” depends on how much you will spend in retirement. Those who study this question report that most people underestimate how much income they will need. If the house will be paid for and the kids educated, that’s a great start. But don’t assume you can get by on half of your current income. The lifestyle you are accustomed to now will be difficult to let go of later, so you should probably count on needing at least 75% of your recent income level.

There are many considerations that go into determining your number: special needs, health care concerns, possible inheritances, proceeds from the sale of businesses, and current and future taxes and inflation. Social security may also be a part of the answer, should we be so lucky that it still exist in the future for anyone but the truly needy. All these considerations and more will go into the equation with the short answer looking something like this example:

I need \$100,000 of pre-tax income a year. I receive \$20,000 a year in Social Security benefits, so I need \$80,000 in investment income, and I want to preserve my principal as financial security for my heirs and myself. Withdrawing 5% per year from my investments means I need a \$1,600,000 portfolio when I retire in 10 years.”

Why 5% per year? For the 85 year period 1926 through 2011, U.S. large company stocks returned 9.8% per year, intermediate-term government bonds 5.4%, and inflation was 3.0%.^v With a traditional portfolio balance of 60% stocks and 40% bonds, the weighted average return has been roughly 8.0% per year. Setting aside 3.0% for reinvestment to protect against inflation leaves a net total return of 5.0%.

Unfortunately, using history as a guide in this process is fraught with problems, not the least of which is that current economic environment will not likely produce returns like the past for some time. The pattern of those returns will also impact your plan, changing the amount available as sustainable income. Therefore, the return assumptions in your plan should be forward looking based on reasonable projections about the future. Our current retirement income plans incorporate ten-year forward return projections of 7.2% for stocks, 3.2% for bonds, and 5.6% for a 60/40 balanced account (see our “Capital Market Projections” in *Industry Insights*). With 3% inflation, withdrawal rates of 3% to 4% are more likely to preserve principal on an inflation adjusted basis. With lower returns likely over the next several years, more clients are choosing to consume some principal during retirement, but only to a certain point, or baseline amount. Another option is to set a higher spending rate early in retirement and a lower one later.

The System

Once you know the goal you can set up a plan to get there. The object is to quantify your financial goals and determine what level of savings and investment returns will be required to achieve those goals. The process can be relatively simple or become progressively more complex with the addition of factors such as inflation, taxes, or statistical simulations to assign a probability distribution range to the output. However, short of finding a reliable crystal ball the future will be different than you predict. Regardless, having worked through this exercise you will have developed long-term goals, set-up a system to monitor your progress, and have a better understanding of the key assumptions that go into the investment process.

The Emotional Stress-Test

In our experience, hardly anyone chooses an asset allocation based solely on the models. Asset allocation is not an exact science that lends itself to a purely quantitative decision without regard to the emotional component. While it's true that common stocks will outperform most other assets over most long-term periods, there is always the concern that this particular period of time may be different. Ultimately, the decision about how much to invest in stocks is determined by both an individual's need and their *capacity* to bear risk. Past experience plays a role, as does the ability to hold longer-term goals in mind regardless of how scary the world may seem at the moment. We recommend starting with a comfortable level of equity exposure and then gradually increasing exposure to desired levels. This approach also helps manage short-term risk by averaging your purchases over time.

Modern investing provides more ways to build portfolios and also more tools for managing risk, a topic we address in a later report. Most importantly, make sure your asset allocation

shoe fits, so you will be able to stick with your plan and not panic when the world around you seems to be coming unglued.

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ⁱ Brinson, G.P., L.R. Hood, and G.I. Beebower. "Determinants of Portfolio Performance." *Financial Analysts Journal*, July/August 1986.

ⁱⁱ Ibbotson, R.G., and P.D. Kaplan. "Does Asset Allocation Explain 40, 90, or 100 Percent of Performance?" *Financial Analysts Journal*, January/February 2000.

ⁱⁱⁱ The Vanguard Group, Inc. "Sources of Portfolio Performance". *Vanguard Investment Counseling & Research*, July 2003.

^{iv} Sommer, Jeff, "Strategies", *New York Times*, March 10, 2013.

^v Ibbotson and Associates, Chicago. "Stocks, Bonds, Bills, and Inflation 2012 Yearbook."

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