

Appendix #3

Beware of Asset Allocation Advice

Asset allocation models are a relatively simple idea based on sound academic theory. By diversifying a portfolio into several asset classes, such as stocks and bonds, you can increase your return and control risk. But this is not an infallible approach. There are limitations that need to be addressed when using an asset allocation model. Many of these limitations are not readily apparent, especially to the large number of financial advisors who use the models to sell investment products.

**Typical 15 year Asset Allocation Model
1983 - 1997**

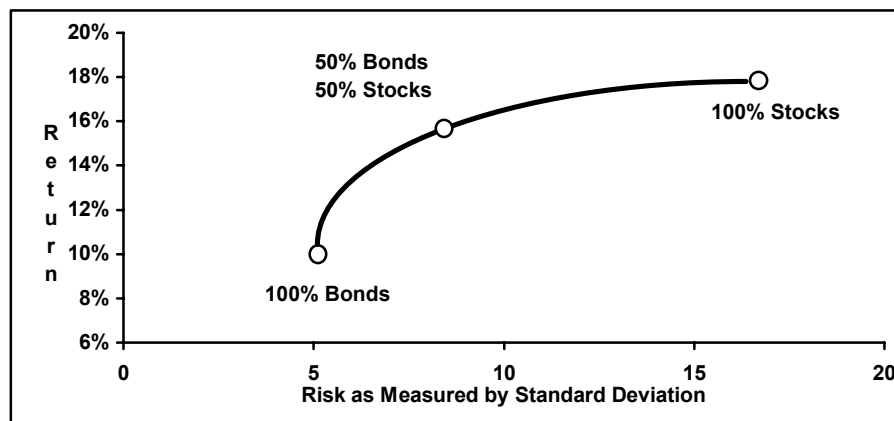


Chart 1

Model Risk and Investor Risk

Chart #1 is a sample asset allocation model. It shows the risk and return of different stock and bond market mixes over the last fifteen years. On the left side of the model is the rate of return, and on the bottom is a measure of portfolio risk. The strong bull market of the 1980s and 90s have caused people to focus on the left side of this asset allocation model, namely the rate of return. Equally as important, though often neglected in a bull market, is the risk of the portfolio. The concept of risk is one of the most misunderstood and mismanaged areas in the investment advice industry.

Asset allocation theory has become deeply imbedded in the mass market for financial products. Nearly every financial advisor has some form of model at their fingertips. Asset allocation theory was originally developed for use by institutional investors. For this reason, the measure of risk was fairly complex. Institutions measure risk by standard deviation, or the variability of portfolios returns over long-periods of time.

Institutional investors understand the basic concept using standard deviation as a measure of risk. Unfortunately, the public does not. Standard deviation does not adequately reflect short-term volatility that occurs in the markets, which is precisely the kind of risk that effects individual investor behavior. When the markets become volatile in the short-term, people lose money. Since the average investor thinks about risk in terms of losing money, or running out of money during retirement, they tend to act impulsively to change their allocation¹. Long-term models, such as the one in Chart #1, assume an investor does not change their allocation over a very long period of time. If an investor does not maintain a stable asset mix, there are in danger of reducing their exposure to stocks at the wrong time. In other words, they start trying to time the markets.

Other Institutional Terms

Statistical numbers like standard deviation, optimization, and utility are important theoretical concepts used at high levels of academic research. However, many advisors who use these terms to sell investment products misunderstand the concepts. One reason for their lack of understanding is due to a lack of training in the investment industry. Statistical concepts are taught at colleges and universities, and as we learned in Chapter 7, most advisors have a limited education outside of their firm. If an advisor does not fully understand the statistical concepts in the model, they tend to recommend portfolios that are too risky for a client. This leaves the investor open to poor portfolio returns as they bail out of a bad market.

Nominal Returns and Real Returns

Most asset allocation models used in marketing brochure and other sales material look like Chart #1. They use *nominal* rates of returns. The returns are not adjusted for *inflation*. This means the model includes the inflation rate as part of the return, which causes investors to have unrealistic expectations about their future returns. For example, from 1973 to 1997 a conservative portfolio of 50% stocks and 50% bonds would have earned a return of 11%. However, adjusted for inflation the return was reduced to 5.5%. Using nominal returns distort reality. Investor and advisors should be using an asset allocation model that adjusts for the inflation rate, such as the one in Chart #2.

¹ John L. Maginn and Donald L. Tuttle, *Managing Investment Portfolios*, 2nd Edition, Warren, Gorham, & Lamont, 1990, pg. 3-2

Inflation Adjusted Market Returns

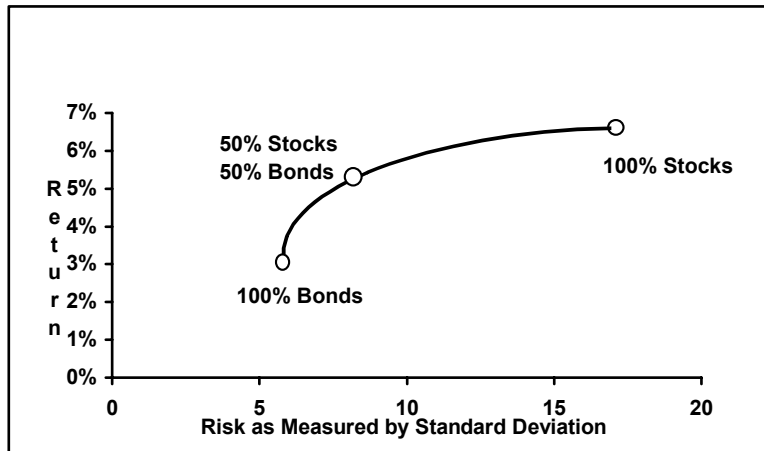


Chart #2

I have one final criticism of advisors who use asset allocation models to sell investment products. Most models are based on the return of a market index, not the returns of actively managed products sold by advisors. As a result, the model in no way reflects the return an investor would have achieved in an actively managed account, especially after fees. Although index funds are a logical fit for portfolios based on asset allocation models, most advisors want no part of them. There is little or compensation for an advisor to sell index funds.

I believe using index returns to sell active products is unethical. Advisors bait investors with models showing index fund returns, then switch to high cost active management. This tactic once again shows that most people in the industry exist to make money from you, not for you.

In summary, the returns of asset allocation models overstate the return to investors and understate the risks. Many advisors who use the models to sell investment products don't really understand the statistics behind them, but use them anyway to push products with higher fees. In a bear market, most portfolios based on faulty allocation assumptions break down as investors true risk tolerance levels are exposed.