By Erik Ford

financial fitness

ALLOCATION IS THE KEY

We are bombarded today with information, technology, news and pseudo-news about how to manage and optimize our investment performance. There is one decision that studies show makes the largest contribution toward our ultimate investing success. That one decision is asset allocation, how we decide to allocate our investments into the broad categories of cash, bonds and stocks.

While there are disputing opinions, there are reputable industry studies (notably Brinsen, Singer and Beebower) that put the long-term results of investment portfolios attributable to allocation at 90% or more. In an industry that spends enormous resources touting expertise and specialized products, the most basic and fundamental of all decisions really drives the train.

So how should the investor approach the allocation decision? Reaching back to past articles, it starts with the planning process and understanding risk tolerance. The mix of assets will determine the expected return and volatility of that return over time. Since risk (volatility) and return move together, you must start by determining the return you need or want and then decide if the anticipated volatility to achieve that return is acceptable. From that you can determine your overall mix. Let us start with the basics of the broad categories: cash, bonds and stocks. These descriptions will be very broad and general for the sake of brevity.

Cash is, well, cash. It obviously has the least volatility, but it has the lowest expected return. In the current environment, the return on cash is near zero, which highlights the hidden risk of holding too much cash, value deterioration due to inflation. We want our investments to increase in "real" value, i.e., buy more stuff in the future than they can buy today. If cash returns less than inflation, which it currently does, its "real" value will diminish over time. The cash allocation, for this reason should be kept to a minimum in a long-term oriented portfolio. Overall cash holdings should be focused on liquidity needs, near term spending and expenses.

Bonds represent loans. As a holder of bonds, you are essentially a lender. They may be loans to corporations, states, countries, or pooled loans to individuals. The returns are driven by length of the loan and interest rate paid. Since the best case is that the loan is repaid with interest, bonds have traditionally played the role of a relatively stable component in a portfolio, generating income. The risks to bond values depend on how creditworthy the borrower is and changes in interest rates. These are not insignificant risks, and it is essential they also be understood. Actual risk and returns can vary widely across the bond category. Ideally bonds are expected to provide a return that keeps up with inflation, or marginally exceeds it, but not much more without taking more risk.

Stocks, or equities, represent ownership of companies and therefore provide the greatest opportunity for real return (in exchange for the greatest addition of repayment risk). We are, of course, generalizing as well, as there are numerous industries, company sizes, or countries to invest in stocks. For this discussion, we are looking at a broad, well-diversified selection of stocks. It is the equity allocation of your portfolio that is going to drive returns and volatility. As ownership interests in commercial enterprises, the prices rise and fall with individual company fortunes and the overall economy. These fluctuations can be quite dramatic (think Feb-March 2020), but over time the variability can be more tolerable if viewed in context and taken in the right overall allocation in your portfolio.

It is important to note that within both the bond and stock categories, prudence dictates being well diversified to spread out the risk you are taking, but that is a topic for another time.

Returning to our primary topic, it is the combination of these three broad categories that make the difference. Energy can be spent searching for the current hot fund manager (who may be cold next year) or trying to time the ins and outs of the market, but studies indicate those decisions are minor factors in the big picture. Determine your preferred allocation and stick with it until your goals or targets change.

A point on market timing that we emphasize often is clearly shown in a study by JP Morgan Asset Management. For the 20 years ended 12/31/2020, an investor who remained fully invested in the S&P 500 would have realized an annual return of 7.47%. If the investor missed the 10 best days in those 20 years, the return drops to 3.55%. less than half. It only goes down from there if more best days are missed. Each of those 10 best days are important. Who can guess when they will occur? It is easier to do harm than good.

Getting comfortable with the appropriate allocation for your goals and tolerance for volatility is the first step. A willingness to stick with it through ups and downs, particularly the downs, is vital. Finally, periodically rebalancing your allocation back to your target is as important as the allocation to start with. Over time, the natural ebb and flow of the markets will change the allocation. Stocks, being more volatile, may gain or lose more than cash or bonds. Bringing your allocation back into the target is important. If stocks decline, you want to add to your equity holdings to bring the allocation back up. Granted this may be difficult, as buying low and selling high, as simple as that sounds, is hard for many of us. Similarly, if stocks have outperformed, reallocating some of the gains to bonds or cash is called for in order to get back to your original target allocation. Again, not always easy to do, but the discipline is important.

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