Assessing the Characteristics of Asset Allocation Mutual Funds

By John Markese

The term 'asset allocation' has a murky meaning in most investors' minds, and when it is attached to a mutual fund, the concept does not get any clearer. Asset allocation may refer to simply creating an investment portfolio or it may imply a more precisely defined goal of diversification. The term is also often associated with market timing—moving investments to different asset categories in anticipation of changing markets.

Strategic asset allocation is usually associated with long-term diversification among asset classes such as stocks, bonds, and cash. Tactical asset allocation is usually the code phrase for market timing, shifting assets among asset classes.

Most asset allocation funds, whatever their approach, are classified generally as balanced funds, a misnomer in that their portfolios are rarely perfectly balanced between stocks and bonds. The traditional balanced fund is a strategic asset allocation fund, holding stocks and bonds in relatively constant proportions. Although these percentages may vary over time, the variations are usually small and market-driven, as stock or bond markets forge ahead or lag behind.

The initial investment question confronting investors in traditional balanced funds is simple: Why not invest in two separate funds—a stock fund and a bond fund—each with exceptional historical performance relative to similar funds, creating in effect a self-directed balanced fund equivalent? This also allows the investor to determine the particular "balance" between stocks and bonds—strategic asset allocation. A tactical asset allocation mutual fund, however, is much more difficult for an investor to manufacture because of the market timing component.

A Look at the Funds

Picking an asset allocation fund is a challenge because there are significant differences among funds.

By their nature, tactical asset allocation funds can be expected to move money around. Comparing different portfolios year-to-year gives some indication of how aggressive these funds can be, and looking at portfolio composition also underlines the differences in funds.

Some of these funds, in addition to stocks and bonds, also hold convertibles, gold, and other assets, so fund expenses might be relatively higher than a fund that is in a single asset category. Portfolio activity may also generate taxes, so along with performance statistics, tax-adjusted returns should be examined and portfolio turnover is worth comparing.

In terms of risk, if these funds provide a higher level of diversification than the average fund, particularly the fund that is invested in only one asset class, then total risk compared to all funds should be relatively lower than average.

The funds listed in Table 1 are all balanced funds that have been classified further as asset allocation funds (tactical) because they have the latitude to shift investments significantly among asset classes according to current and anticipated market conditions. Funds that hold other funds—funds of funds—are excluded because of their unique structure, although they are in a sense asset allocation funds.

The portfolio composition changes shown confirm the tactical asset allocation strategy of many of these funds. The portfolio categories are stocks, bonds, cash, and other. The 'other' category, while routine and unimportant for most funds, can contain some unusual investments for asset allocation funds. Investments such as Swiss bonds, gold bullion, futures, options, convertible bonds, and convertible preferred stock can be found in asset allocation funds and are collectively reported in the 'other' category. With the potential investment diversity, a look at an asset allocation fund's annual report that shows all investments and groups them by type is even more of a must-read before investing.

An example of how assets can shift in an asset allocation fund is the change in the portfolio composition between June 1995 and June 1996 of the Strong Asset Allocation fund. The

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stock position jumped from 34% to 56% of the portfolio, while bonds fell from 51% to 39%, and cash declined to 1% of the portfolio from 13%. Some asset allocation funds had even more dramatic shifts, while others were static for the period.

Also reported in Table 1 is the percentage of the portfolio invested in foreign securities—stocks or bonds. This figure includes American depositary receipt stocks (ADRs), which are foreign stocks traded on U.S. exchanges. Excluded from Table 1 are asset allocation funds that are global funds, funds that invest in U.S. and foreign markets, and asset allocation foreign funds, funds that invest in non-U.S. markets. But clearly many of these U.S. asset allocation funds have significant foreign exposure. When looking at your total portfolio, all the investments you hold, without factoring in these foreign holdings in an asset allocation fund, you may easily underestimate the total foreign exposure of your portfolio. Trouble is that, by their nature, asset allocation funds move investments around, so pinning down what precisely is your foreign exposure at any point in time may be tricky.

The foreign security component of these funds range from a high of over 25% to a low of zero. Often, funds with foreign securities hold both foreign stocks and bonds, lending a foreign currency exposure to the portfolio. Strong Asset Allocation, for example, holds stocks and bonds of firms in 20 countries representing 14% of portfolio value, a position worth noting for overall portfolio allocation decisions.

Judging Performance: Benchmarking

At the bottom of Table 1 are two index funds that are passively managed—the Vanguard Index Trust 500 invested in large common stocks and the Vanguard Bond Index. These are helpful for crafting a tailored benchmark, which allows you to compare the fund's performance to unmanaged indexes that are always fully invested and therefore do not do any market timing or security selection. Ideally, the portfolio weights from the beginning of the period should be used, but as an approximation, Table 1 lists the portfolios as of September of 1996 and 1995.

Here is how to make your own rough benchmark, using Dreyfus Asset Allocation as an example. As of September 1996, the fund had 60% of the portfolio in stocks, 33% in bonds, and 7% in cash. An index fund with this same asset allocation would have had an approximate return for 1996 of:

	Allocation		Return		
Vanguard Index 500 (stocks):	0.60	×	22.8	=	13.6%
Vanguard Bond Index (bonds):	0.33	×	3.5	=	1.1%
Treasury bills (cash):	0.07	×	5.2	=	0.3%
Total Benchmark return:					15.0%

This tailored benchmark return, while higher than the 14.9% return for 1996 before taxes of the Dreyfus Asset Allocation fund, compares favorably. If there is a significant amount of the portfolio in foreign securities or the 'other' category, a reading of the annual report will help to adjust the benchmark—for instance, convertible bond investments could be moved to the bond category. If gold bullion is part of the 'other' category, then some estimate for the return on gold multiplied by the percentage amount in gold should be used.

The bull and bear market returns capture how the funds move when the market runs up and when it stumbles. Not surprisingly, most funds fall between the stock index and the bond index—in an up market, their performance is substantially less than the stock index and in a down market, there is a tendency to fall more than the bond index.

If you are investing taxable money, it is important to look at the amount of annual taxes the returns may generate. The annual total return for many of these funds is distinctly different from the tax-adjusted return. The tax-adjusted return assumes maximum federal tax rates on income and the capital gains tax rate on capital gains. For example, BB&K Diversa fund had a total return of 10.6% for 1996, but only a 6.2% tax-adjusted return.

On the plus side, these performance figures should be considered along with the risk these funds take, and these funds tend to have total risk levels that range from average to low when compared to all funds. The risk measure used for comparison captures variability in return; the more volatile the return, the higher the risk category.

Other Notable Statistics

The turnover ratio is a measure of portfolio activity, with higher percentages indicating higher activity. A 200% portfolio turnover ratio indicates that the fund turned over the portfolio twice by value during the year. Turnover ratios average 100% for funds and the funds range from a high of 446% (Strong Asset Allocation) to a low of 9% (Permanent Portfolio, apparently a refreshingly apt fund name). Higher portfolio turnover results in higher transaction costs, which cuts into returns. In addition, the more buying and selling, the more the chance of unwanted capital gains distributions.

Finally, the expense ratio details the percentage of portfolio value spent on management fees and other expenses, but not including transaction costs or loads (sales commissions) other than the annual distribution 12b-1 charge. Expense ratios for domestic stock funds average about 1.15% and bond funds are close to 0.75%. Funds with expense ratios above 1.5% are getting expensive and expense ratios above 2.0% make it difficult for the portfolio manager to do well on a relative performance basis.

Summing Up

Asset allocation funds become popular after market corrections and a bear market climate is an ideal marketing environment for these funds. They do tend to have less risk than a straight common stock fund. But be cautious. It is difficult for an asset allocation fund that aggressively swings money around to do well, particularly if the fund generates

Table 1.
Asset Allocation Funds

Fund	Date	Portfolio Composition Stocks (%)	Portfolio Composition Bonds (%)	Portfolio Composition Other (%)	Portfolio Composition Cash (%)	Foreign Holdings (%)		Average Annual Return 1996 (%)	Average Annual Return 1995 (%)	Average Annual Return 1994 (%)	Average Annual Return 1993 (%)	Average Annual Return 1992 (%)	Bull* Mkt (%)	Bear** Mkt (%)	Total Risk Rank	Turn-over (%)	Exp Ratio (%)
BB&K Diversa	9/30/96	55	43	0	2	25	Return:	10.6	20.5	–9.4	21.5	4.4	31.5	–9.8	blw av	68	1.99
	9/30/95	48	33	5	14		Tax-Adj.:	6.2	17.4	–10.4	20.4	3.3					
Berwyn Inc	9/30/96	19	28	47	6	7	Return:	13.9	21.0	–1.1	16.9	21.7	39.2	–5.4	blw av	38	0.68
	6/30/95	24	23	41	12		Tax-Adj.:	10.1	17.6	–3.7	12.8	17.4					
CGM Mutual	9/30/96	74	26	0	0	2	Return:	23.6	24.3	–9.8	21.8	6.0	49.5	–9.9	abv av	192	0.87
	6/30/95	68	31	0	1		Tax-Adj.:	18.6	22.0	–11.3	18.4	3.1					
Columbia Balanced	9/30/96	51	46	0	3	3	Return:	11.8	25.0	0.0	13.6	8.8	44.1	–5.1	blw av	133	0.69
	6/30/95	47	42	1	10		Tax-Adj.:	8.4	22.1	–1.5	11.2	7.2					
Crabbe Huson Asset Alloc	9/30/96	56	35	0	9	2	Return:	6.8	20.2	–0.9	18.2	12.1	31.7	–5.8	blw av	252	1.47
	4/30/95	54	46	0	0		Tax-Adj.:	4.4	16.5	–2.9	15.8	10.2					
Dreyfus Asset Alloc	9/30/96	60	33	0	7	7	Return:	14.9	23.5	1.6	—	—	47.1	–4.4	av	370	1.25
	10/31/95	63	37	0	0		Tax-Adj.:	12.5	17.9	0.3	—	—					
Fidelity Asset Manager	9/30/96	45	38	0	17	12	Return:	12.7	18.1	–6.7	23.2	12.7	32.6	–9.2	av	131	0.93
	9/30/95	49	26	1	24		Tax-Adj.:	9.8	16.7	–8.1	20.5	10.7					
Fidelity Asset Mgr Growth	9/30/96	71	21	0	8	14	Return:	17.5	19.9	–7.4	26.3	19.0	39.8	–10.1	av	138	1.01
	9/30/95	70	21	3	6		Tax-Adj.:	14.4	19.1	–8.3	24.7	18.1					
Fidelity Asset Mgr Income	9/30/96	22	72	0	6	17	Return:	7.8	16.6	–1.4	15.3	—	26.8	–3.9	low	148	0.80
	9/30/95	27	58	2	13		Tax-Adj.:	5.0	14.5	–3.2	13.1	—					
Fidelity Balanced	9/30/96	58	35	6	1	14	Return:	9.3	14.9	–5.4	19.2	7.9	25.1	–7.5	blw av	247	0.79
	7/31/95	33	48	12	7		Tax-Adj.:	7.3	13.0	–6.6	15.8	4.9					
Hotchkis & Wiley Bal Inc	9/30/96	48	51	0	1	7	Return:	11.7	24.7	0.8	12.5	9.4	42.9	–3.9	blw av	92	1.00
	6/30/95	55	44	0	1		Tax-Adj.:	8.7	22.1	–2.2	9.1	6.6					
IAI Balanced	9/30/96	51	46	2	1	11	Return:	14.7	18.5	–1.5	4.9	—	42.8	–8.6	av	193	1.25
	9/30/95	55	32	9	4		Tax-Adj.:	8.2	17.3	–3.7	3.4	—					
INVESCO Industrial Inc	9/30/96	79	17	1	3	6	Return:	16.7	27.3	–3.9	16.6	0.9	47.9	–6.5	av	63	0.93
	6/30/95	69	26	0	5		Tax-Adj.:	13.3	25.1	–6.6	13.7	–1.0					
INVESCO Total Return	9/30/96	63	33	0	4	3	Return:	12.3	28.6	2.5	12.3	9.8	51.1	–4.8	blw av	10	0.89
	8/31/95	60	29	0	11		Tax-Adj.:	11.0	26.8	1.2	10.1	7.9					
Jurika&Voyles Balanced	9/30/96	56	0	28	16	0	Return:	15.4	25.4	–2.2	17.0	—	44.8	–4.4	av	69	1.35
	6/30/95	59	35	0	6		Tax-Adj.:	11.5	22.8	–4.0	16.0	—					
Maxus Income	9/30/96	33	24	41	2	0	Return:	9.2	16.1	–4.5	8.7	7.8	26.0	–4.7	low	78	1.92
	6/30/95	5	69	26	0		Tax-Adj.:	6.6	13.1	–7.2	5.7	4.5					
Montgomery Asset Alloc	9/30/96	45	50	1	4	3	Return:	12.8	32.6	—	—	—	75.6	—	—	225	1.30
	6/30/95	46	52	0	2		Tax-Adj.:	9.3	30.8	—	—	—					
Northeast Investors Trust	9/30/96	14	76	6	4	5	Return:	20.1	17.2	2.2	23.5	17.4	39.3	–2.3	blw av	32	0.66
	9/30/95	18	77	4	1		Tax-Adj.:	16.2	13.0	–1.6	19.2	12.4					
Permanent Portfolio	9/30/96	30	32	25	13	11	Return:	1.6	15.4	–2.9	15.5	2.5	18.7	–5.6	blw av	9	1.35
	7/31/95	32	30	25	13		Tax-Adj.:	0.5	14.4	–3.5	14.8	1.7					

Table 1.
(continued)

Fund	Date	Portfolio Composition Stocks (%)	Bonds (%)	Other (%)	Cash (%)	Foreign Holdings (%)		Average Annual Return 1996 (%)	1995 (%)	1994 (%)	1993 (%)	1992 (%)	Bull* Mkt (%)	Bear** Mkt (%)	Total Risk Rank	Turn-over (%)	Exp Ratio (%)
Preferred	9/30/96	46	31	0	23	0	Return:	15.0	32.8	–2.6	10.5	—	57.6	–8.4	av	38	1.04
Asset Alloc	6/30/95	54	21	0	25		Tax-Adj.:	12.5	29.1	–4.0	8.7	—					
Schwab Asset	9/30/96	57	37	0	6	14	Return:	11.1	—	—	—	—	—	—	—	44	0.89
Bal Growth	—	—	—	—	—		Tax-Adj.:	10.2	—	—	—	—					
Schwab Asset	9/30/96	76	19	0	5	19	Return:	14.4	—	—	—	—	—	—	—	46	0.89
High Growth	—	—	—	—	—		Tax-Adj.:	13.6	—	—	—	—					
SteinRoe	9/30/96	48	31	13	8	20	Return:	17.0	22.6	–4.2	12.3	7.8	43.9	–7.0	blw av	87	1.05
Balanced	9/30/95	38	11	48	3		Tax-Adj.:	13.3	19.8	–6.3	9.6	4.1					
Strong Asset	6/30/96	56	39	4	1	14	Return:	10.4	21.9	–1.6	14.5	3.2	38.1	–5.8	blw av	446	1.13
Allocation	6/30/95	34	51	2	13		Tax-Adj.:	6.4	18.2	–3.3	10.8	0.1					
T. Rowe Price	9/30/96	59	33	4	4	20	Return:	14.2	28.1	—	—	—	—	—	—	47	1.05
Personal Bal	5/31/95	58	40	0	2		Tax-Adj.:	12.2	26.3	—	—	—					
T. Rowe Price	9/30/96	40	43	5	12	19	Return:	11.7	24.7	—	—	—	—	—	—	34	0.95
Personal Inc	5/31/95	39	51	0	10		Tax-Adj.:	7.7	22.4	—	—	—					
USAA Invest	9/30/96	74	18	1	7	24	Return:	17.8	18.3	–1.1	23.7	6.3	41.5	–5.3	av	36	1.15
Cornerstone	5/31/95	74	25	1	0		Tax-Adj.:	15.5	16.4	–3.8	22.1	4.9					
USAA Invest	9/30/96	43	44	0	13	0	Return:	11.1	22.7	–2.7	13.7	4.9	36.2	–4.5	blw av	202	0.82
Growth & Tax	5/31/95	41	59	0	0		Tax-Adj.:	8.9	20.9	–4.8	11.3	3.3					
USAA Invest	9/30/96	76	19	3	2	19	Return:	22.1	—	—	—		—	—	—	40	1.66
Growth	11/30/95	74	19	0	7		Tax-Adj.:	20.4	—	—	—						
Value Line	9/30/96	44	30	0	26	4	Return:	26.6	36.1	3.4	—	—	84.0	–7.1	av	244	1.38
Asset Alloc	9/30/95	63	6	0	31		Tax-Adj.:	20.1	32.2	2.9	—	—					
Value Line	9/30/96	58	28	10	4	1	Return:	17.3	26.2	–4.4	8.2	1.7	50.8	–8.1	av	83	0.93
Income	6/30/95	62	23	3	12		Tax-Adj.:	12.0	23.7	–5.9	3.5	–1.2					
Vanguard	9/30/96	35	40	0	25	0	Return:	15.7	35.4	–2.4	13.4	7.5	62.1	–8.4	av	47	0.47
Asset Alloc	9/30/95	37	30	0	33		Tax-Adj.:	12.3	32.2	–4.0	10.9	5.4					
Averages							**Return:**	**13.9**	**23.4**	**–2.5**	**15.9**	**8.5**	**43.3**	**–6.4**	**blw av**	**121**	**1.07**
							Tax-Adj.:	**10.8**	**20.8**	**–4.3**	**13.4**	**6.1**					
Index Funds																	
Vanguard Bond	9/30/96	0	91	3	6	—	Return:	3.5	18.1	–2.7	9.6	7.1	23.7	–5.1	low	36	0.20
Index Tot Mkt	6/30/95	0	98	0	2		Tax-Adj.:	1.0	15.3	–5.2	6.7	4.1					
Vanguard	9/30/96	100	0	0	0	—	Return:	22.8	37.4	1.1	9.8	7.4	76.9	–6.7	abv av	4	0.20
Index 500	6/30/95	100	0	0	0		Tax-Adj.:	21.7	36.1	–0.1	8.6	6.2					

* *Bull market period: July 1, 1994, through December 31, 1996.*
** *Bear market period: February 1, 1994, through June 30, 1994.*

high expenses. For taxable accounts, keep your eye on aftertax returns.

There is no one model for these funds, so you have to pore over the prospectus and annual report to find out what they are and what they can do. Every investor should have strategic asset allocation as a goal. Tactical asset allocation requires belief. Market timing when done right is hard to beat but executing market timing right is hard to do.