

Choosing the Right Portfolio Allocation Approach for You

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Article Highlights

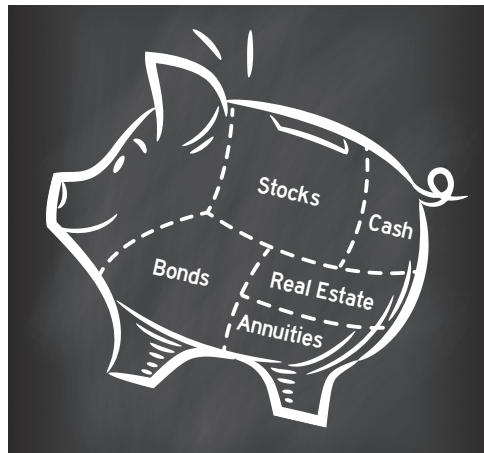
- A portfolio made up solely of stocks has historically realized the highest returns, but required a willingness to stay invested through crashes and bear markets.
- The simplest strategy approach to a diversified portfolio is to set the allocation initially and change it only when a significant life event occurs.
- Segmenting a portfolio by time or investing style can make the allocation process easier to visualize and understand.

One of the longest-running debates in finance centers on the most critical part of investing: allocation.

Opinions vary on what asset classes to allocate to, how much should be put into each asset class and when adjustments should be made. Volumes have been written on the subject. Yet a single simple consensus eludes us.

In this article, I discuss the various approaches to portfolio allocation, explaining both their positive and negative traits. The options I cover include not doing anything, rebalancing, segmenting and tactical. Segmenting is a catchall phrase to cover strategies such as bucketing and core and satellite. Though each strategy has its proponents, none are one-size-fits-all. Financial goals, wealth, age, emotional tolerances for risk, the willingness to be actively involved and other personal traits all need to be taken into account. Plus, there is enough overlap between the various strategies that it is possible to use a hybrid version of them.

The big key is to find an approach that works for you and stick to it. None of these strategies will fully protect your wealth from the fluctuations of the market, changes in inflation or other macro events. What they will do is steer you through short-term market turbulence to help you achieve your long-term goals. Failure to adhere to an approach during difficult market or economic conditions will cause you to miss out on the benefits offered by the strategy and potentially cause long-term harm to your portfolio. This is why it is important to think through each approach carefully



and ensure that it is a good fit for you. Despite the vast amount written on the subject, allocation remains a very personal decision.

Allocate Solely to One Asset Class

The most basic asset allocation strategy is to only hold one asset class, such as stocks or bonds. A portfolio made up solely of stocks has historically realized the biggest returns on capital of any asset class.

At the other end of a spectrum, a portfolio made up solely of high-quality bonds, intended to be held until maturity, almost fully guarantees a stream of capital and a preservation of capital in absolute terms.

A portfolio allocated solely to large-cap stocks has realized an annualized return of 10.1% since 1926, according to the 2014 Ibbotson SBBI Classic Yearbook. A portfolio allocated solely to small-cap stocks would have realized an even higher return of 12.3%. As good as these numbers sound, an investor would have had to withstand significant market volatility to realize them. The returns assume an investor did not alter his or her portfolio during the crashes of 1929 and 1987 and did not adjust his or her portfolio during severe bear markets, such as the one that occurred between 2007 and 2009.

An all-stock allocation can make sense for someone who is young and has decades before retirement. He or she is in a position to financially tolerate market swings and will benefit from the compounded returns that time brings. This

young investor will, however, need the emotional tolerance to withstand the price volatility of such an allocation. Not everyone has this tolerance for risk.

An all-bond allocation can make sense for someone who wants the assurance of cash flows and fears losing capital in the market. A retiree looking to assure his or her fixed costs are covered could use a bond ladder to provide the needed income stream. (A bond ladder holds bonds with different maturity dates.) The downside is the low level of real (“inflation-adjusted”) growth. An all-bond investor risks having his or her wealth grow at an inadequate pace to keep up with inflation, thereby reducing purchasing power (the ability to buy goods and services with a set amount of money.) There is also the potential for default, so the bond issuer and the bonds themselves must be chosen wisely.

The remainder of the strategies discussed in this article assumes some type of diversification is preferred over an all-stock or an all-bond portfolio.

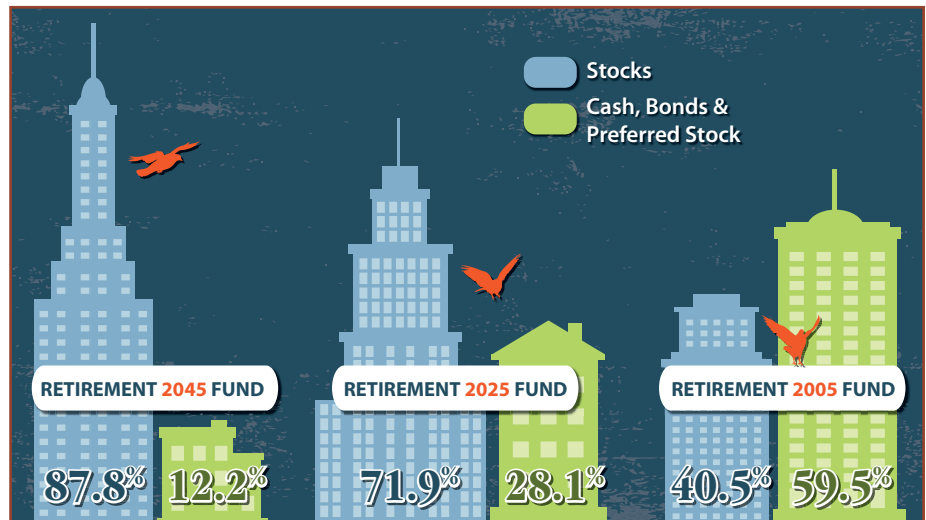
Set and (Mostly) Do Nothing

The simplest of approaches for an investor who wants a diversified portfolio is to establish an initial mix of asset classes and then only adjust it when a significant life event is approached or occurs. An example would be initially placing 70% of the portfolio dollars into stocks and 30% into bonds during one’s working years. The investor would not make any adjustments to the portfolio allocation until he or she is near retirement, at which point the portfolio may be adjusted to a more conservative allocation.

Aside from its simplicity, this approach allows the market to determine how much risk the portfolio is incurring. William Sharpe refers to this as adaptive allocation. Transactions are limited to the replacement of securities or funds held within the portfolio due to specific changes of a particular security or a fund itself. If index funds are used, transaction and tax costs would be minimal.

Volatility under such an approach will increase to the extent that the pro-

Figure 1. Rebalancing to a Glide Path



Source: T. Rowe Price.

portionate allocation to stocks grows. A portfolio that shifts from 70% stocks to 85% stocks will experience greater variances in its short-term returns than a portfolio that is periodically adjusted back to its 70% stock target. The higher volatility could cause an investor to panic during a bear market.

Sequence of returns is another risk to this approach, especially for retirees. If returns for the primary asset class (e.g., stocks) are bad for the first 10 or 15 years of retirement and withdrawals are made from the portfolio during that time, the investor’s wealth could be less than if a more active approach to portfolio allocation were followed. On the other hand, if an investor enjoys great returns during the first half of retirement, the market conditions of the second 15 years won’t matter as much, because he or she will be further ahead.

Rebalancing

Rebalancing is the process of adjusting your portfolio back to a targeted allocation. It can be done based on time intervals, it can be trigger-driven, or it can be based on a combination of the two. Rebalancing keeps your portfolio from drifting too far away from the targeted allocation.

Rebalancing is often thought in

terms of bringing the portfolio back to a static allocation. However, rebalancing can also be used as a part of a glide path, where allocations evolve as a person ages.

Rebalancing to a Static Allocation

A static allocation is one where a specified mix of asset classes is preferred, such as 70% stocks and 30% bonds. When employed with a static allocation, rebalancing is a buy low/sell high strategy. It causes an investor to shift money from assets that have performed well and into assets that have underperformed. By doing so, rebalancing can prompt an investor to go against his or her emotions and buy when valuations may be depressed. I personally like rebalancing because it gives the investor a sense of control when a market correction or a bear market occurs. Rather than wondering what to do, the investor has a plan of action, and one that benefits his or her long-term wealth.

One approach to rebalancing is to adjust allocations on a time-specific basis, such as quarterly, semiannually or annually. Exchange-traded funds (ETFs) and mutual funds that equally weight their holdings rebalance based on time intervals.

Another rebalancing approach is to use triggers. This means adjusting the

portfolio back to its targeted allocations when the asset class weightings have strayed off target by, say, five or 10 percentage points. Triggers give the portfolio room to float, and thereby take advantage of market conditions, without straying too much off target. As long as they are not set too tightly, triggers will result in fewer transactions than rebalancing every three, six or 12 months.

It is also possible to combine time and triggers to determine when to rebalance. Vanguard suggests that annual or semiannual rebalancing when a portfolio's allocations are five or 10 percentage points off target strikes a reasonable balance between controlling risk and minimizing costs. (I check my 403(b) plan—which is the equivalent of a 401(k) plan—every May and October to see if it needs to be rebalanced. These months mark the respective ends of what have historically been the best and worst six-month periods for U.S. stocks. If any of my major asset class allocations are off-target by more than five percentage points, I rebalance.)

Rebalancing is a risk reduction strategy. Over a long enough period of time, it will cause a diversified portfolio to underperform a portfolio with an allocation that is left unchanged. This will happen because rebalancing periodically takes money out of stocks and puts it into other asset classes. While this reduces the downside potential during periods of market turbulence, it limits the upside potential during bull markets.

Costs are tied to the number of transactions made and the types of accounts the transactions are made in. Tax costs for this—and any other strategy requiring periodic adjustments to be made—can be offset by taking capital gains in tax-sheltered accounts (e.g., IRAs) and losses in taxable accounts.

Rebalancing to a Glide Path

A glide path evolves the target allocation as an investor ages. A portfolio following a traditional glide path will be heavily allocated to stocks when an investor is young and hold a significant allocation to bonds when an investor

is retired. The portfolio is periodically adjusted to ensure it becomes more conservative over time.

This is the approach followed by target date funds. T. Rowe Price's mutual funds can be used to show how it works (Figure 1). The Retirement 2045 Fund (TRRKX) has an 87.8% allocation to stocks; the remainder of its portfolio is allocated to cash, bonds, and preferred stock. The Retirement 2025 Fund (TRRHX) follows a more moderate allocation with a 71.9% allocation to stocks as it evolves for retirees who are about 10 years from retirement as of the date this article is written. The Retirement 2005 Fund (TRRFX) uses a conservative 40.5% allocation to stocks and is designed for those who are already in retirement.

There are disagreements about what a proper glide path actually is. The companies offering target date funds all use different glide paths, meaning the allocations for two target date funds with the same retirement date can differ. At retirement, some schools of thought say the portfolio's allocation should immediately become more conservative. Other viewpoints believe that the portfolio's allocation should continue to evolve gradually for a period of time after the date of retirement. A newer study suggests starting retirement with a conservative allocation and evolving it to become gradually more aggressive throughout retirement.

Like rebalancing to a static allocation, adhering to a glide path can result in transaction costs being realized when adjustments are made. The type of glide path followed will also impact the level of returns realized. The more conservative that a glide path is, the smaller the upside will be and the less downside volatility will be incurred. The returns realized by glide paths will also be influenced by future interest rate increases.

Segmenting the Portfolio

Segmenting a portfolio by time or investing style can make the allocation process easier to visualize and understand. These type of approaches split the portfolio into various groups, with a different allocation strategy used for each group. The bucket strategy may be the most well-known, but there are other approaches such as core and satellite.

Bucket Strategy

A popular approach to managing a retirement portfolio is the bucket approach. A simple bucket approach created by Harold Evensky and Deena Katz splits retirement assets into a cash flow reserve (CFR) portfolio and an investment portfolio (IP). The CFR is very conservative and designed to ensure there is adequate cash to cover one year's worth of spending. The IP is designed to provide long-term growth. Other approaches use three buckets: a very conservatively allocated bucket (such as cash, money market accounts and high-quality short-term bonds) to cover cash flow needs for the next two to five years, a moderately allocated bucket (intermediate- and long-term bonds, high-quality dividend-paying stocks) intended for the next three to 10 or 15 years, and a more aggressively

Figure 2. The Three-Bucket Strategy



allocated (mostly or all stocks) bucket designed to cover periods of 10 years or more (Figure 2).

In a bucket approach, the most conservative bucket is refilled each year. The two-bucket approach moves one year of needed cash flow from the IP into the CFR. The three-bucket approach moves one year of needed cash flow from the aggressive bucket to the moderate bucket and one year of needed cash flow from the moderate bucket to the conservative bucket. This ensures short-term spending needs are always met regardless of how the market is doing. The downsides are transaction costs, the risks of having too much money too conservatively invested and draining the most aggressive bucket.

Segment by Goal

A variation of the bucket strategy is to allocate by goal. Many people already do this. An example is parents who use different accounts to save for a child's college education and to save for their retirement. This approach allows the allocation to be tailored for each goal. The downside is the risk of losing sight of one's overall allocation, which may be more aggressive or conservative than an investor realizes it actually is.

Core and Satellite

The core and satellite approach is used to combine active and passive strategies. The "core" is the largest portion of the portfolio. It holds low-cost investments, most commonly index mutual funds or ETFs. The "satellites" are active strategies (Figure 3).

A version of the core and satellite approach I've heard of is to have a traditional, long-term strategy for the core and very aggressive strategies for the satellites. The satellites are made up of short-term stock trading, short-term option and currency trading strategies. Individual investors using this may not think of it as a core and satellite approach, but the underlying idea is the same—only take big risks with a small portion of the portfolio. You could also use annuities or a bond ladder as your core to ensure a "safe" level of cash flow and use stocks as a satellite for growth. Other versions include using index funds in the core and active strategies in the satellites or having a traditional stock/bond allocation for the core and using various investments in the satellites (e.g., master limited partnerships, or MLPs; commodities; alternative funds). The mix depends on the investor and, if he or she uses one, the adviser.

The percentage of the portfolio allocated to the core is a variable; I have not seen a set number given. Part of the reason for this may have to do with the number of satellites used. A very simple core and satellite approach may have a large core (80% of the total portfolio) and one satellite. A more complex approach may use multiple satellites, with the satellites themselves differing in size.

The key to a core and satellite approach is to have the satellites complement the core without severely altering the risk of the portfolio. The satellites should provide better opportunities for capital gains, more income or more diversification. If they clearly don't, then the money should put back into the core. Additionally, the satellites should not be so big or so risky that they can cause significant harm to the portfolio. In other words, losses in any single satellite should not derail the investor from achieving long-term investment goals.

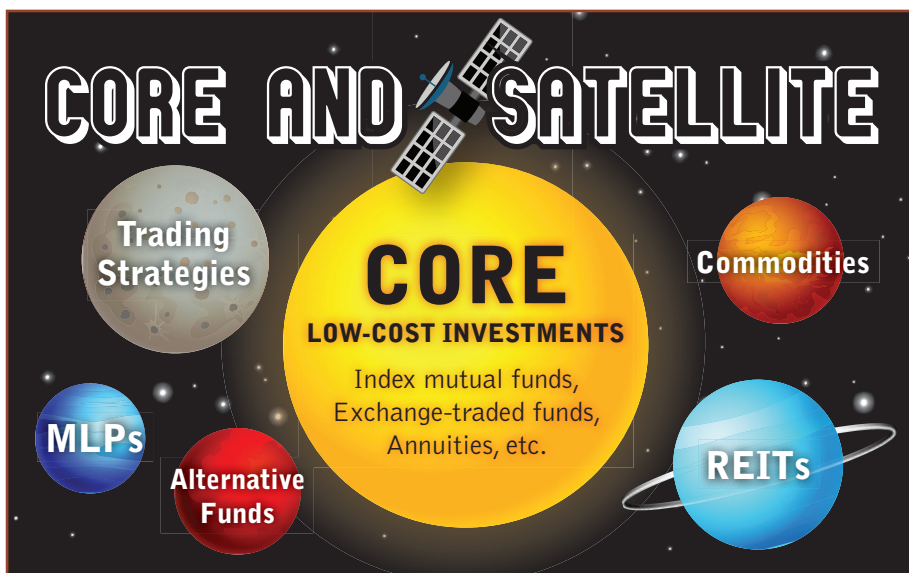
The approaches and investments held in the satellites can boost transaction and tax costs. Complexity rises with the number of satellites used. Diversification benefits can also be lost or impaired if a satellite is not significantly different from the core or from the other satellites.

Tactical Allocation

Tactical allocation approaches seek to take advantage of changes in price momentum, valuations or seasonal anomalies. These approaches shift portfolio dollars from one asset class to another or shift dollars within an asset class. They are risky, require discipline and are not suitable for many investors.

Price momentum approaches can rely on chart formations. A common strategy is to stay allocated to stocks when a major market composite is above a certain technical indicator. An example would be to stay allocated to U.S. stocks when the Dow Jones industrial average is above its 200-day moving average and pull out of stocks when the Dow falls below the long-term trendline. Jeremy Siegel says that such a strategy would have kept an investor from

Figure 3. The Core and Satellite Approach



experiencing the brunt of past bear markets, but the costs of executing it diminish long-term returns.

Tactical valuation approaches shift investment dollars from expensive assets to cheap assets. Unlike rebalancing, the portfolio is not adjusted back to a targeted allocation; rather, it is realigned. Adherents to these type of approaches often look at valuations based on several years of earnings rather than the more common trailing 12-month ratios. One example would be to overweight or underweight stocks based on Robert Shiller's cyclically adjusted price-earnings (CAPE) ratio. Mebane Faber of Cambria Investment Management suggests that the CAPE ratio could also be used to shift dollars from expensive countries to the cheapest countries. Jeremy Grantham's money management firm GMO relies on long-term allocations for forecasting seven-year returns for various asset classes.

An alternative version is to look at relative yields. This approach favors overweighting stocks when their earnings yield (earnings divided by price) exceeds that of bonds. Bonds should be overweighted when their yield exceeds the earnings yield of stocks.

Seasonal anomaly approaches prompt an investor to move in and out of stocks based on the calendar. The Stock Trader's Almanac says the months of November through April are the best six months and May through October are the worst six months for U.S. stocks. (At least one study has found similar patterns for foreign stock markets as

well.) Under a strict seasonal approach, an investor allocates to stocks during the best the six months and pulls out of them during the worst six months. An alternative approach, suggested by both S&P Capital IQ's Sam Stovall and The Stock Trader's Almanac's Jeff Hirsch, is to hold more conservative stocks during the worst six months and more aggressive stocks during the best six months.

All of these tactical allocation strategies will incur higher transaction costs. They may prompt an investor to make the wrong decision at the wrong time, especially if past trends do not repeat or if future asset class returns turn out to be different than expected. The financial markets can act in unpredictable ways for longer-than-anticipated periods of time. These trends also require a high level of discipline and risk tolerance, since they will prompt an investor to make decisions that are emotionally uncomfortable. Failure to properly follow a tactical asset allocation approach can cause an investor's returns to significantly lag what he or she would have realized by following a less active, long-term approach.

Which Approach Should Be Used?

Asset allocation is a very personal decision, and no single approach will work well for every single investor. The best advice I can give you is to pick an approach that fits with your personality, your desired level of engagement and your risk tolerance.

Many of these approaches can be mixed together. In fact, you may want to do this if your goal is to follow a "best of" approach. For example, it is possible to combine rebalancing and a core and satellite approach with a bucket strategy. Your moderate and aggressive buckets would be comprised of a core and a satellite approach with annual rebalancing used to ensure the respective allocations to each asset class or investment strategy stay within a specific range. This rebalancing would also free up cash to shift from one bucket to another.

The big key is to find an approach that works for you and stick with it. Most allocation strategies fail during bear markets not because they are flawed in some manner, but rather because investors stop adhering to them. A good allocation approach won't prevent short-term losses. What it will do is ensure both that your short-term needs are met and that your long-term goals are achieved. Failing to stick with the chosen approach during a period of market turbulence can cause lasting financial harm to your portfolio.

Finally, realize that any allocation approach is only as good as the assets placed within the portfolio. Care always needs to be taken when choosing and managing individual securities and funds.

The online version of this article includes an appendix of links to previous *AAIL Journal* articles that discuss the various allocation approaches discussed here in more detail. ▲

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