

Why a New Allocation Approach Is Needed

An Interview With James B. Cloonan

Article Highlights

- Investors are paying much more to protect against downward market moves through traditional diversification strategies than they are receiving in actual benefit.
- The traditional approach of comparing average returns to volatility made for a simple model, but fails to consider the actual sequence in which returns occurred.
- Realizing an additional 4% a year in annualized return is going to double or triple your money at retirement.

In his forthcoming book, "Investing at Level3," AAI founder James Cloonan challenges the traditional manner in which risk has been viewed and how investors have been told to allocate. We discussed the reasons why he thinks a change in investment practices is needed.

—Charles Rotblut, CFA

Charles Rotblut (CR): Your book, "Investing at Level3," is a departure from conventional wisdom as well as academic theory. You're arguing that the traditional thought process of allocating to stocks and bonds, including increasing exposures to bonds as somebody ages, isn't necessarily the best strategy. You haven't previously addressed this in your columns in the AAI Journal. Did this new approach come to you suddenly, or is it a viewpoint that evolved over time?

James Cloonan (JC): The realization of the problem certainly happened gradually. I suddenly realized that it's akin to repairing an old refrigerator—at some point, you have to stop using duct tape and get a new refrigerator.

Initially the academic community simply assumed that return volatility was distributed according to the normal curve, but it became obvious that it wasn't normal. It wasn't clear exactly what the true distribution of return volatility was, so over time different approaches to deal with long tails—extreme market moves—were proposed. None of them really worked, however.

So, you really have to look at the whole thing rather differently. That part of it did come suddenly. At one point, I decided a whole new approach was needed.

CR: Where did you find the shortcoming to be? Is it in the concept



of diversifying in order to reduce the magnitude by which the portfolio swings in value—what a lot of people in the investment community refer to as standard deviation? Or is it more just in how general portfolio theory has been carried out in practice?

JC: I think there are several problems with current practice. The general approach to controlling risk separates the risk that is unique to each stock from the risk of the overall market. Current practice eliminates or reduces the unique risk by diversifying among stocks and reduces market risk by asset allocation or diversification between stocks and other assets such as bonds.

I think a very serious problem is that risk aversion has really gotten out of hand. Nobody likes risk and we want to avoid it, but we're paying to avoid it. If we look at risk avoidance as insurance, we're paying much more in premiums for the insurance than the protection is worth, at least in my opinion. That's one of the major directions that my book takes and discusses. We have many examples of people giving up 2% a year of return in order to protect against a \$100,000 loss somewhere along the line. This means, cumulatively, that they're paying probably over \$1 million to protect against a \$100,000 loss.

We need to get investors to be less concerned about risk that doesn't really matter over the long term and more concerned about investing in the best-returning strategies. That's a major focus of the book.

CR: Your viewpoint contrasts with much of investing theory and practice. As you know, many academics and practitioners not only

look at standard deviation—the variance in returns—but also focus on how returns look on a risk-adjusted basis. One of the most famous indicators used for this, of course, is the Sharpe ratio. What would you suggest to replace the approach of viewing returns relative to their volatility?

JC: I think the problem is that we try to make things simple and elegant. The general approach is to use the mean expected return and the volatility, just two measures, to determine effective portfolios. The Sharpe ratio even turns those two into one. It's the ratio of what you get for the risk you take. So they've made it really simple. But we've given up something along the line in this quest for simplicity.

When you have a series of returns, you not only have what they are each year, you have the exact dates when they occurred and you have the exact way they changed from period to period. When you get to a standard deviation or a measure of volatility that's a single number, you give up all that. You're giving up any measure of momentum, which most people believe is one of the major ways that you can beat the market. So you just throw that away in order to get simplicity in a beautiful model that just doesn't relate to the real world.

I think you have to go back and look at the real distribution of returns in history. I think you're much better off looking at what would have happened to a particular portfolio at different periods of time than to trying to reduce it to a simple mean and standard deviation or Sharpe ratio.

CR: So you're looking at the historical sequence of returns, the order in which those returns actually occurred during certain points of time, as a base for your portfolio strategy?

JC: Yes. To assess risk, I think we should use the return data directly rather than trying to convert it into a standard type of distribution. History doesn't always repeat itself exactly, but it's the only thing we have. The modern portfolio approach is taking history and trying to make it into a simplistic number. I think it's much better to use

history directly and look at what would have happened if you had done this or had that portfolio through severe downturns such as 1972, 2008 or any of the other bad times.

CR: How does an individual investor reconcile your viewpoint against what they've been hearing all this time?

JC: They've been hearing some versions of what was wrong. If you read, as a lot of people have, "The Black Swan" by Nassim Nicholas Taleb (2nd Edition, Random House, 2010), you'll be exposed to the idea that the normal or near-normal distributions that we talk about just don't exist.

If you had the distribution of returns that occurred in 2008, it would be like having a distribution curve where the people walking down the street are two feet tall, 10 feet tall, three feet tall and seven feet tall. Averaging those heights gives us a mean of maybe 5½ feet, but the ranges are very different than the mean and a normal curve suggest.

CR: Using this method, how does someone deal with an unexpected downturn? Particularly if, say, somebody's nearing retirement or otherwise needs to withdraw a sum of money out of their portfolio to fund living expenses or some other planned expense?

JC: When you approach the time where you're going to withdraw money, you have to be more concerned with short-term risk. But even there, I think the standard procedures are much too safe. One rule of thumb has been that the amount you should have in stock is 100 minus your age. Well, people retire at 70 these days. That means only 30% of their portfolios should be in stock. And they've got 30 years to go. Bonds and cash may not even keep up with inflation. I think that is real risk.

My approach in the book is to start to be safe four years out from retirement and start to put some assets in safe investments. The goal is that in most of the down markets, which are basically over in four years, you just want to have four years of safe money that you can use to pay your bills without having to sell stock at the bottom.

CR: Diversification has been commonly touted as the only free lunch on Wall Street, but you're arguing that it's not free. You believe that investors are actually incurring certain trade-offs and certain costs by trying to diversify, say, to 60% stocks and 40% bonds?

JC: Yes. If you think that all investments have equal returns, then I guess it's a free lunch. But that's not the way the world works. If you have the possibility of three investments that are expected to give you 10%, 15% and 20% annual returns and you take all three, you're going to get a 15% return. If you take only the best one, however, you will have a 20% return. So, you're giving up 5% in portfolio return to diversify. It might be worth it, but you have to realize that you are paying something for the protection.

CR: So your approach is really to try to estimate how much the reduction in risk is worth and compare that to the cost. How does somebody go about doing that?

JC: Well, if you shift, for example, from 100% stocks with perhaps a 12% annual return (as in the models outlined in my book) to the typical 60% stock/40% bonds portfolio, you're down to about an 8% annual return. That's 4% a year difference. Four percent a year is going to triple or quadruple your money at retirement. So you've given up maybe millions of dollars in order to protect against some modest risk, and the amount of protection you get in many different cases is just not worth that.

CR: It doesn't seem as if professional investors and financial planners have really picked up on that: The fact that you're giving up a lot of return in exchange for this diversification to protect against a period of bad market conditions versus just trying to maximize your long-term wealth.

JC: Well, I hope that there's been more emphasis on keeping more in stock even at older ages or closer to retirement. In a recent interview in the *AALJ Journal*, Jane Bryant Quinn amazingly started to show the importance of doing this, and she's a very conservative person ["Using Cash and Short-Term Bonds to Avoid Taking Losses in Retirement,"

May 2016]. She pointed out that you just have an awful lot of your life ahead at retirement. You have to be a long-term investor if you're going to make enough to keep up with inflation.

CR: *Staying on the topic of the equity-risk premium, the Level3 approach almost seems like it's designed to take advantage of the benefits of excess return for stocks.*

JC: A lot of this should not be amazing—the fact that we're overpaying to reduce risk. That risk isn't all that important. Academics have known for a long time that there's an equity-risk premium, that stocks don't have enough risk to justify the extra return over bonds. We're getting a free gift here when we invest in stocks rather than bonds or cash.

This kind of explains a lot of what I've been talking about. That we're overpaying to avoid risk. When we have this wonderful, wonderful strange phenomenon of the equity-risk premium that has been going on for centuries. And it may go on forever, or it could stop if investors suddenly change their viewpoint. If everyone reads my book and changes their way of investing, the equity-risk premium will disappear—just kidding!

CR: *In terms of the long term, I know*

you talk about long-term investing in your book, but could you define it for people who are reading this?

JC: I use between three and five years, four years actually in most of our examples. That's because all the down markets—except for the Great Depression, which is a separate topic—are basically over in four years. You could go to five years if you want to be conservative. It may be worthwhile to cut it down to three years, because down markets are usually most of the way back by the end of three years. I know this cuts out the Great Depression, but I don't think something that bad could happen again because of government policies and the fact that we have limits on leverage and that options now have to be controlled with money deposited for them. A lot of things have changed. Socially, it's changed. We're not going to have Patton and MacArthur chasing the veterans with tanks and sabers out of Washington DC as they did in 1932.

CR: *You are obviously taking on accepted financial theory, and you wrote a lot about the math involved in these returns, but you also give a lot of actionable strategies in the book. Could you briefly describe who this book is intended for? What type of investor should read this?*

JC: I show a range of approaches

from passive to aggressive. The passive approach I suggest is all exchange-traded funds (ETFs), but there could be mutual funds mixed in instead. While I do discuss various alternatives, the only reason you would change is if a new fund came along that was better at doing what it was doing than one of the ones you had. Otherwise, you keep the same balance and you don't have to pay much attention to your portfolio at all. I just feel that by doing that, you can do significantly better than just following a cap-weighted index fund.

I also address investors who want to get more involved. Particularly if you're wanting to invest in smaller-capitalization stocks, it's hard to get an ETF that handles small caps properly. There are just too many problems. So I discuss active approaches.

The book shows a variety of strategies that have outperformed the market averages over time. Readers can either develop their own strategy or evaluate the ones that exist and decide which ones are best. So, I think anyone from the person who doesn't want to spend very much time at all on investing to the person who would like to design new processes will find the book beneficial. ▲

See the inside back cover of this issue for more details on the book "Investing at Level3."

James B. Cloonan is founder and chairman of AAIL. His forthcoming book is "Investing at Level3: Higher Returns With Minimal Risk for the Long-Term Individual Investor." Find out more at www.aail.com/authors/james-cloonan. Charles Rotblut is a vice president at AAIL and editor of the AAIL Journal. Follow him on Twitter at twitter.com/CharlesRAAIL.