Why Asset Allocation is Important

Although asset allocation and diversification are words that are regularly used when thinking about proper portfolio construction, more often than not lip service is not followed by actual attention to the process of putting together a grouping of investments that makes sense. What makes sense is a collection of securities within a variety of asset classes with the objective of gaining worthwhile returns while limiting risk exposure.

It's not hard to do.

One traditional approach to asset allocation has been a 60/40 split between stocks and bonds, decreasing the percentage allocation to equities as investors get older. This has not been a bad way to go, but simply thinking in terms of U.S. stocks and bonds overlooks the opportunities available by considering a wider variety of asset classes, including international stocks, real estate, and high yield (a.k.a., junk) bonds.

I recently completed a study of asset class returns from 1989 thru August 31, 2017 that is quite telling. In the study, I reviewed the yearly returns, the volatility of returns (standard deviation), and the number of negative returns over the period. The asset classes included were growth stocks, value stocks, large cap stocks, small cap stocks, developed country stocks, emerging markets stocks, investment grade bonds, high yield bonds, real estate stocks, and commodities.

Here are the results:

The highest returns, by far, over the 28-year period were from emerging markets stocks: 16.0%. BUT, those returns were accompanied by two and half times the volatility of the average of all asset classes. What's more, for this asset class, 12 of the 28 years showed losses, one in excess of 50%.

Four of the asset classes (growth stocks, large cap stocks, value stocks, and real estate stocks) provided returns in the 11.5-12.0% range, though here too the volatility was still 30% higher than the average of all asset classes. For this group, there were five down years over the period.

The weakest returns were provided by investment grade bonds, which averaged gains of 7.0% annually and had only three down years. Even so, that performance may not be indicative of the future for this asset class since bonds had a three-decade-plus rally from 1980 on as interest rates plunged from the mid teens to near zero in the wake of the Great Recession of 2008-9.

A simple solution worth considering would be to construct a portfolio with equal percentages allocated to each of the 10 asset classes. For the period considered, the annual returns would have been 10.2% with overall volatility lower than all asset classes other than investment grade bonds. Taking this one step further, one might well choose to stay away from commodities, in which case annual returns would have increased by 0.5% without a significant jump in risk.

Although there are numerous combinations of asset classes that are probably worth considering (and potentially more profitable), the key point is that with this kind of real diversification it's quite likely that worthwhile gains will accrue while dampening risk significantly.