

The Power of Asset Allocation
Jonathan Tiemann
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Five consecutive weeks of market declines, a steady stream of nervous geopolitical news—both incendiary happenings on the other side of the globe and not-quite reassuring comments from our own public officials about our state of domestic readiness—a continuing drip of cautious words from corporate executives, and the suspicion of new corporate scandal lurking around every corner, have left many investors anxious and raw-nerved. It is the kind of market that tests the discipline of thoughtful investors. It is also the kind of market that sometimes prefigures opportunity.

Losing money in the market is never fun, and it's natural to respond to losses by wondering whether to stay invested, risking further losses. What is happening in our current market? It's impossible to know for sure, but it seems likely that stock prices have been falling as a result of three of the factors. We have had a string of poor corporate reports, which indicate that market expectations of corporate strength may have been too generous in the past. Prices fell as a result of revised estimates. Second, geopolitical uncertainty has increased the perception of the general level of risk in the economy, and thus in stocks. Stock prices may have fallen for this reason, too. Third, the market premium for risk, the amount of return the market has to offer to induce investors to hold risky assets, seems to have increased as well. If so, it would have contributed to the drop in stock prices, but it would also mean that today's market may offer more upside opportunity than the market of two years ago.

The current market presents a textbook example of why disciplined investors make and implement asset allocation plans. An investor holding a balanced portfolio would likely have weathered the current weak market better than it might seem from watching the news or the stock market averages. Investors allocate their portfolios across domestic stocks, foreign stock, bonds, and cash to create opportunities for growth, at a reasonable level of risk. The table below shows returns on various asset class benchmarks since last August 31. From August 31, 2001 to June 24, 2002, the S&P 500 index has returned -11.7%. In that difficult market, a portfolio allocated 40% to US equities, 10% to international equities, 45% to a 5-year US Treasury note, and 5% to cash, would have lost some value, but could have returned (assuming benchmark performance) -3.1%, a modest loss for such a time.

	8/31/01- 9/30/01	9/30/01- 12/31/01	12/31/01- 3/31/02	3/31/02- 6/24/02	8/31/01- 6/24/02	9/30/01- 6/24/02
S&P 500	-8.1%	+10.7%	+0.3%	-13.5%	-11.7%	-4.0%
EAFE	-10.1%	+7.0%	+0.5%	-6.4%	-9.6%	+0.6%
5-yr US Treas	+3.0%	-1.5%	-1.0%	+4.4%	+4.8%	+1.7%
Cash	+0.2%	+0.7%	+0.4%	+0.3%	+1.7%	+1.5%
40/10/45/5 portfolio	-2.9%	+4.3%	-0.3%	-4.0%	-3.1%	-0.2%
48/12/35/5 porfolio	-4.0%	+5.5%	-0.2%	-5.7%	-4.6%	-0.6%

Source: S&P 500: BARRA 8/31/02-5/31/02; S&P 5/31/02-6/24/02. EAFE: Morgan Stanley Capital International. 5-yr US Treas: OCM estimates based on yields from Yahoo! Finance. Cash: Vestek 90-day T-bill index. 40/10/45/5 portfolio is a weighted average of 40% S&P, 10% EAFE, 45% 5-yr Treas, 5% cash. 48/12/35/5 portfolio calculated in a similar fashion. Results are simulated based on benchmark returns. Actual experience may differ.

The table shows the importance of asset allocation. In spite of the drop in stocks during the current quarter, our hypothetical balanced portfolios sustained only modest declines since the end of August, and are nearly even with the end of September. Even during September 2001, the presence of bonds in those portfolios softened otherwise sharp declines.

Do we know what will happen next? No. Risky assets are just that—risky. In the back of many investors' minds is the possibility of a major event—a terrorist attack, a further flare-up in the Middle East or South Asia, or something unexpected. Such an event could cause a very sharp drop in equity prices. But we allocate across asset classes precisely because the stock market is not always generous. If a major event occurs, we could also see a flight to quality, in which investors redeploy their assets toward US Treasury securities. If so, Treasuries could rally sharply. In addition, the US dollar could decline sharply, increasing the dollar value of international assets. If both US and international stocks fell by 25%, but bonds rallied by 5%, then our 40/10/45/5 portfolio would return around -10.3%. A loss of that magnitude would be unpleasant, but not a disaster for most investors.

Why allocate even 40% to US stocks? Because a number of things could happen to spark a powerful rally in stocks. If tensions in the Middle East and South Asia ease, if economic data improve, if next quarter's corporate earnings contain positive surprises, or if somehow anxiety over potential terrorism eases, then markets could deliver a handsome payoff to those that bore the risk in the market. The data above for 9/30/01-12/13/01 give a real-life example of the possibilities.

Rallies of the strength we saw in last year's fourth quarter are not unusual. In the fourth quarter of 1998, shortly after a series of international fiscal crises and the collapse of Long-Term Capital Management, the S&P 500 jumped by 21%. Even in the 1930s, the markets staged some truly remarkable rallies—in 1932, the market jumped by more than 38% two months in a row.

The recent downward pressure on stock prices seems to be the result of three factors: disappointing corporate news, a perceived increase in risk in business conditions, governance of specific companies, and the geopolitical outlook, and an increase in the premium investors demand for bearing market risk. For long-term investors, a portfolio balanced roughly equally between stocks and bonds represents a reasonably conservative balance between the opportunity to capture that increased premium if conditions improve, and the risk that a major event could cause a sudden drop in stock prices.

The actual nature and effects of unexpected events are unpredictable, so actual outcomes could be significantly worse or better than recent history or our analysis of one hypothetical outcome of a major event. But the point of the analysis is clear: by mixing asset types in their portfolios, investors have a good chance of insulating themselves from severe losses.

The reason for maintaining an allocation to equities is to be in a position to benefit from an improvement in market conditions. If part of the market's fall represents an increase in the equity risk premium, then positive stock market news could result in attractive portfolio gains. Moving too aggressively to avoid loss involves the risk of missing the next move upward. Waiting until that move is in progress only increases that risk, since it's impossible to tell during an upward move whether it is the start of a great bull market, or simply a bear market rally. A well-structured, balanced portfolio stays in position to grow with a recovering economy, while moderating the risk of a sharp downward move in equity prices.