Does Asset Allocation Work?
November 1, 2002

At the end of the 1990s, while many investors seemed to be throwing aside normal standards of prudence, many investment advisors and similarly conservative types continued to spend endless hours preaching the old testament of diversification and asset allocation. At times, the best they could accomplish was to induce investors to buy a "diversified" portfolio of hot growth funds, which likely held mostly the same stocks.

Since the excess of the 90s has given way to the pain of the 00s, those same advisors (along with countless others that insist they were always in that wise camp) have been exhorting their followers to protect what remains of their investments by following the advice they claim to have been giving all along – make an asset allocation plan and diversify broadly. Many of the investors themselves, meanwhile, have retreated to the perceived safety of cash.

Who was right? Would asset allocation actually have lived up to its promise? Let's see what the numbers say.

It's easy enough to produce charts demonstrating the virtues of asset allocation for very long horizons, but let's concentrate on the periods that really matter to advisors right now – the last one, three, and five years (to September 30, 2002, before the recent rally). During the last one, three, and five years (to 9/30/02), the broad US stock market as represented by the Russell 3000 index has returned -18.83%, -11.57%, and -1.78% annualized. And that's with a very broadly diversified portfolio. Most notably, the losses in the last 2-1/2 years have been great enough to more than wipe out the gains of the previous 2-1/2 years. Investors that rode the market through the entire five-year cycle are down modestly. The ones that are really hurting are those that missed the big gains in the first half of the period (about 60% cumulatively from 9/30/97 to 3/31/00), but piled into the market just in time for the long slide back down (a loss of about -43% cumulatively from 3/31/00 to 9/30/02).

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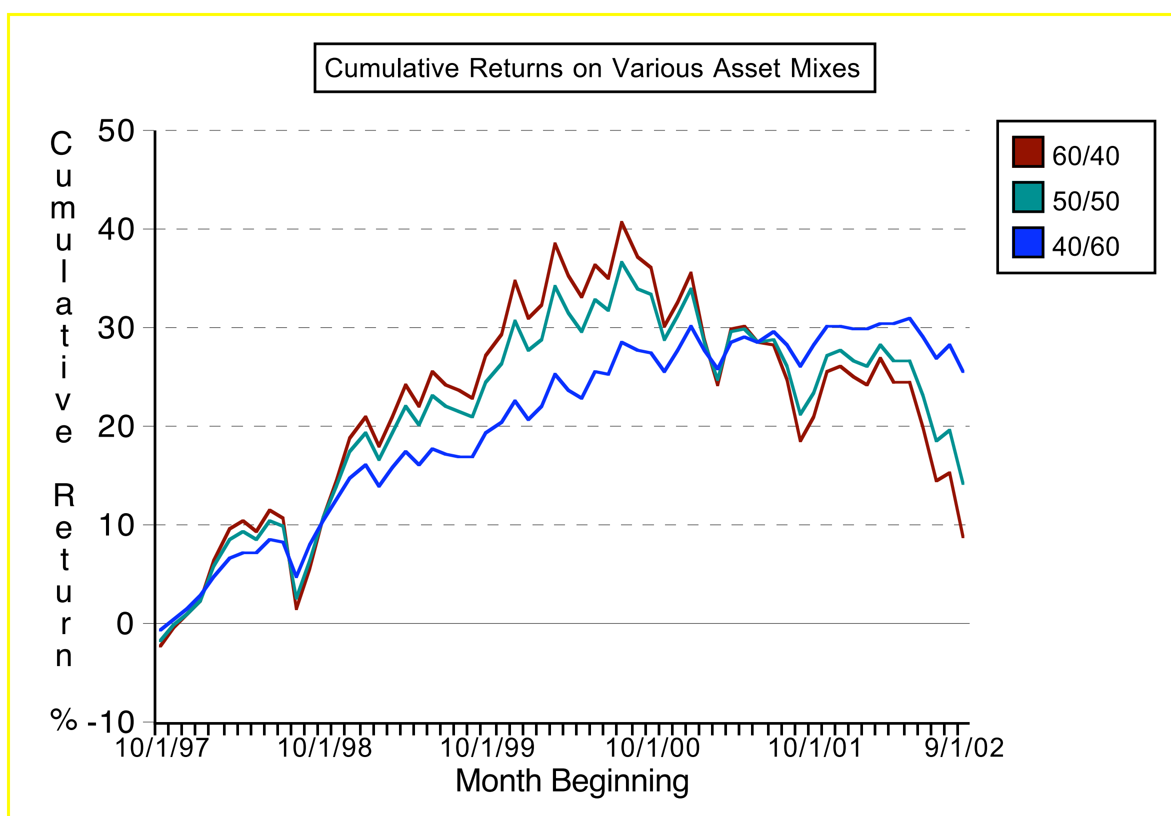
The slide in the stock market has been truly painful, and many investors have become deeply discouraged. But the past rough period in the market has been a triumph, of sorts, for the asset allocation crowd. The figure below shows the cumulative returns, from 9/30/97 to 9/30/02, of three different asset mixes: 60/40 equity/debt, 50/50, and 40/60. In each case, the equity portion was 80% US, represented by the Russell 3000 and 20% international, represented by the Morgan Stanley Capital International EAFE Net Dividend Index. Each allocation has 5% in cash (part of the debt side), represented by one-month Treasury bills, courtesy of the Center for Research in Securities Prices, and the remainder is in US bonds, represented by the Lehman Brothers Intermediate Government/Credit Index.



The results in the figure show the striking success of asset allocation. While the 60/40 mix has shown a decline from its peak (it has returned -8.27% and -3.97% for one and three years to 9/30/02), a steadfast 60/40 investor would still be ahead of the game, +8.83% cumulatively and +1.71% annualized, for the full five years. And unlike an investor that just stayed in cash, our 60/40 investor would have enjoyed the October 2002 rally.

Even more striking are the 40/60 results. We often characterize a portfolio with only 40% equity as moderately conservative, and the past year's results have borne out that claim.

Our 40/60 investor is up +25.75% cumulatively for the five years (+4.69% annualized), the only one of our hypothetical mixes that beat cash, which returned a cumulative +23.80%. For the past three years, the 40/60 mix has had an annualized return of +2.39%, and for the 12 months ended 9/30/02, the 40/60 mix was very close to flat, at -0.37%. And again, our 40/60 investor would have been in the market to catch the surprise rally in October 2002.

There is no magic in the results that a well-allocated, well-diversified portfolio can deliver. The most important factor is that each of our hypothetical portfolios has a significant allocation to bonds. The Lehman Intermediate Government/Credit Index returned +44.05% cumulatively in the five years to 9/30/02 – not a huge return, but an important offset to the weakness in equities. In addition, the bond index's returns for the last one and three years are +8.09% and +9.07% (annualized). This performance is no big surprise, since often (though by no means always) when equities suffer a dramatic fall, interest rates also fall, which means that bonds perform very well. 2001 and the first nine months of 2002 were true to form in that respect.

Asset allocation is no panacea, and is certainly no guarantee of great results. But if difficult times are the most persuasive test of any strategy, then the past couple of years have provided a powerful argument in favor of asset allocation.

– Jonathan Tiemann
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Source for all figures: TIA analysis, based on index data as indicated in text. Figures are for periods ending September 30, 2002, unless otherwise indicated in text. Return figures for periods longer than one year are annualized unless specified in text as cumulative.

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