Asset Allocation Mistakes

MARKET COMMENTARY BY JIM O'SHAUGHNESSY: SEPTEMBER 8, 2009

"IT AIN'T SO MUCH WHAT PEOPLE KNOW THAT HURTS THEM AS WHAT THEY KNOW THAT AIN'T SO."

ARTEMUS WARD

I think today's financial advisors could benefit from thinking about this quote from 19th century humorist Artemus Ward, one of Abraham Lincoln's favorite authors. According to a September 3, 2009 article in the *Wall Street Journal* entitled "Rethinking Stocks' Starring Role—Some financial professionals are challenging the traditional view that long-term investors should load up on equities," there is a growing chorus of financial advisors who think that "the classic 60-40 split between stocks and bonds—the formula that many balanced funds use to allocate investments—ignores alternative asset classes that can return returns with different levels of risk." The article quotes Rob Arnott, the chairman of Research Affiliates, a money manager in Newport Beach, California who "found that from February 1969 through February of this year, investors in 20-year Treasurys, rolling to the nearest 20-year bond and reinvesting the income, would have beaten investors in the S&P 500—a 40-year record of bonds beating stocks." The article goes on to point out that Mr. Arnott had moved the allocation to stocks in the PIMCO All Asset Fund that he helms to just nine percent as of June 30, 2009.

Mr. Arnott is not alone—according to The Leuthold Group, a market consultancy in Minneapolis, in 2008, investors yanked \$51.8 billion from open-end US equity funds while they poured \$92.7 billion into US open-end bond funds. For 2009, the additions to open-end US bond funds soared to \$217.6 billion while investments in open-end US equity funds received a paltry \$10 billion inflow. All told, between January 1, 2008 and August 26, 2009 investors stripped \$41.8 billion from open-end US equity funds while they added over \$310 billion to open-end US bond funds.

The flight from equities is pervasive—our salespeople are hearing time and again that financial advisors are decreasing their allocations to stocks—in one case to as low as five percent. In many instances, we hear that advisors are moving their stock allocation to just 15 percent, with fixed income and alternatives making up the balance of their portfolios. When we ask mutual fund wholesalers what they are selling, the answer is always "bond funds, bond funds, and more bond funds."

Closing the Barn Door After All the Horses Have Gone

But we think investors "know what ain't so." As readers of my March 16th commentary know, we've seen *other* 40-year periods where bonds have beaten stocks and we are far more interested in what happened *afterwards*. Behavioral economists study the biases and flawed rules of thumb that hamper investors' performance and one of them is called the *recency bias*. In a nutshell, the recency bias describes our tendency to associate more importance to recent events than to the more distant, and forecast well into the future a continuation of events from our recent experience while discounting those that occurred long ago. Thus, investors at the end of 1999 thought that annual double-digit returns from equities were bound to continue, whereas investors today feel tremendously stung by equities and are pouring all of their money into bond funds *after* bonds have offered stellar performance. In other words, investors tend to do *exactly the wrong thing at exactly the wrong time*. Dalbar, Inc. is a Boston-based investment consultancy that has been measuring the effects of investors' decisions to buy, sell and switch in and out of various mutual funds. And what are the results over the past 15 years? The average investor earned *significantly less* than the mutual fund performance would suggest because of their atrocious market timing.

I believe that all of these changes to asset allocation are coming at *exactly the wrong time* and that investors who follow this herd-like move to overweight bonds versus stocks will be bitterly disappointed over the next ten years. They are guilty of not looking at the long-term cycles of the market and therefore are blind to what has happened historically. We decided to look at how two asset allocation schemes performed as the US economy emerged from a recession—the first uses the traditional 60-40 split between stocks and bonds. For the equity portion, I used the preferred equity allocation outlined in my book *Predicting the Markets of Tomorrow* which calls for 50 percent of the equity portion of the portfolio to be in large-cap value stocks; 35 percent in small-cap stocks and 15 percent in large-cap growth stocks. For the bond portion of the portfolio we put 45 percent in long-term US treasuries; 45 percent in intermediate-term US Treasuries and 10 percent in T-bills. The second allocation is one similar to the one many advisors are recommending today with 15 percent of the portfolio in core equities (the S&P 500) and the 85 percent balance in intermediate and long-term US Treasuries as well as T-bills. (The exact allocation for each portfolio and which indexes we used as proxies can be found at the end of this commentary.)

The table below shows the results for each asset allocation after each recession back to 1926 as well as the excess return of the traditional 60-40 portfolio over the 15-85 portfolio. The results are eye-opening and should be examined by every investor considering a big shift to bonds now. On average, the 60-40 traditional mix outperformed the 15-85 mix by more than 21.5 percent one year after the recession's end; by over 8 percent annualized for three years; over 6.4 percent for five years and by more than 6.4 percent annualized for ten years! The average ten-year return for the 15-85 portfolio following all recessions back to 1926 was an annual gain of 6.40 percent versus an average annual gain of 12.84 percent for the 60-40 portfolio. That means that if you currently have $250,000 in your retirement account and follow the 15-85 route being advocated by so many advisors today, ten years from now your account would be worth $464,897 versus your account growing to $836,702 following the 60-40 portfolio and getting the average results we have seen from this study—nearly double the value of the bond-centric portfolio!

		Subsequent Returns (%)											
Recession		60-40 Portfolio				15-85 Portfolio				Excess Return (60-40 Portfolio minus 15-85 Portfolio)			
Start Date	End Date	1-Year	3-Years	5-Years	10-Years	1-Year	3-Years	5-Years	10-Years	1-Year	3-Years	5-Years	10-Years
10/31/1926	10/31/1927	21.88	-1.65	-4.93	6.99	7.57	4.74	2.12	4.36	14.31	-6.39	-7.05	2.63
4/30/1929	2/28/1933	138.38	49.60	23.84	16.05	15.69	11.09	7.42	5.61	122.68	38.51	16.42	10.44
5/31/1937	5/31/1938	16.66	7.32	15.03	13.92	9.99	4.36	4.58	4.14	6.67	2.96	10.44	9.79
2/28/1945	9/30/1945	4.01	4.68	8.79	11.82	1.17	1.58	3.11	3.99	2.84	3.10	5.68	7.83
11/30/1948	9/30/1949	28.04	16.31	14.81	14.06	5.70	3.74	4.99	3.85	22.34	12.57	9.81	10.21
7/31/1953	4/30/1954	36.82	15.55	15.66	11.69	6.14	3.29	3.52	4.34	30.68	12.26	12.14	7.35
8/31/1957	3/31/1958	34.41	17.38	11.72	11.76	1.96	4.89	4.48	3.69	32.44	12.49	7.24	8.08
4/30/1960	1/31/1961	11.35	8.47	11.51	9.42	4.14	4.65	4.32	3.96	7.21	3.82	7.19	5.47
12/31/1969	10/31/1970	20.11	10.47	6.60	11.18	16.00	8.77	6.93	5.94	4.12	1.70	-0.33	5.24
11/30/1973	2/28/1975	34.02	16.26	16.18	16.98	10.07	6.68	4.21	8.78	23.95	9.58	11.96	8.21
1/31/1980	6/30/1980	17.75	22.69	18.76	15.56	-2.31	12.21	12.92	12.34	20.05	10.48	5.84	3.22
7/31/1981	10/31/1982	25.84	18.07	15.41	14.28	8.83	13.34	13.21	12.34	17.01	4.73	2.20	1.94
7/31/1990	2/28/1991	23.85	16.10	14.84	13.19	12.91	11.39	10.42	9.87	10.94	4.72	4.41	3.33
3/31/2001	10/31/2001	-9.64	8.41	9.73	—	3.67	5.57	5.26	—	-13.31	2.84	4.47	—
	Average	**28.82**	**14.98**	**12.71**	**12.84**	**7.25**	**6.88**	**6.25**	**6.40**	**21.57**	**8.10**	**6.46**	**6.44**

Stocks Have Never Lost Money After Inflation Over Any 40-Year Period—but Long Bonds Have

What's worse, investors making these changes now are doing so at precisely the time they should be *over allocating* to stocks. Look at the excess return (see previous page) generated by the 60-40 portfolio coming out of the recession ending in 1933—the next five years saw an annual compound return for the 60-40 portfolio of 23.84 percent versus just 7.42 percent for the 15-85 portfolio! I've highlighted the two worst recessions since 1926 in the table (see previous page) since our recent experience is closer to these than to the more mild recessions also included. If your clients have made it through the worst drop in the equity market with a portfolio that was dominated by equities, it makes no sense at all to now move them to a portfolio dominated by bonds. That would have been a prudent move *before* the plunge in stocks but seems downright foolish to do so afterward. As we've seen since the March lows, equities can recover *dramatically* and have done so following every recession back to 1926. Right now the ten-year Treasury yields just 3.35 percent before any anticipated inflation is factored in to the return. It seems probable that, as the government attempts to pay for all of the accumulated deficits, interest rates will rise—perhaps substantially—over the next ten years. If that happens, the ten-year note that you buy today will *decline* in price, perhaps substantially.

If you survived a 50-foot drop off a cliff, would you proceed to break any bone that *wasn't broken* in the fall? Of course not, but I fear that is exactly what will happen to those advisors moving their clients disproportionately into bonds. Keep in mind that even after inflation is taken into account, stocks have *never* had a 40-year period where they lost money, whereas US long-term Treasuries managed to turn in a *loss* of 2.62 percent per year for the 40 years ending September 1981. Your clients depend on you for the best advice and to provide them a path to the best future returns possible, and we passionately believe that investment in equities is the path to the highest returns ten years hence.

Here are the overall weights and indexes used to derive the returns for this commentary (the portfolios are rebalanced annually back to target weights):

OSAM 60-40 Portfolio	
Fama French Large Growth Index	8.26%
Fama French Large Value Index	27.52%
Fama French Small Growth Index	13.76%
Fama French Small Value Index	13.76%
US Long-term Treasury	18.35%
US Intermediate-term Treasury	14.68%
US T-bills	3.67%

OSAM 15-85 Portfolio	
S&P 500	15.00%
US Long-term Treasury	42.50%
US Intermediate-term Treasury	34.00%
US T-bills	8.50%

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