

Asset Allocation After the Crash:

When nothing goes as planned, do you change your plan?

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Asset allocation, the process of dividing your money into different types of investment vehicles, is the heart of a sound investment plan. It is a long-range strategy—one you should stick with in order to prevent an overabundance of either fear or optimism from undermining your efforts to build wealth over time¹. While it may be tempting to react to the market mayhem of the past 18 months by tinkering with your allocation strategy, only clear and unambiguous changes in either the nature of markets or your individual circumstances should dictate whether or not any change in asset allocation strategy is warranted. The challenge is to distinguish between sensible reasons to change, and the temptation to change based on pure emotion.

It's natural to want to change things, especially after a year like 2008. We tend to think that making changes will automatically improve our investment results as compared with simply leaving well-enough alone. Indeed, the temptation to change your mix of stocks and bonds is enhanced by the fact that there may, in fact, be logical reasons to change:

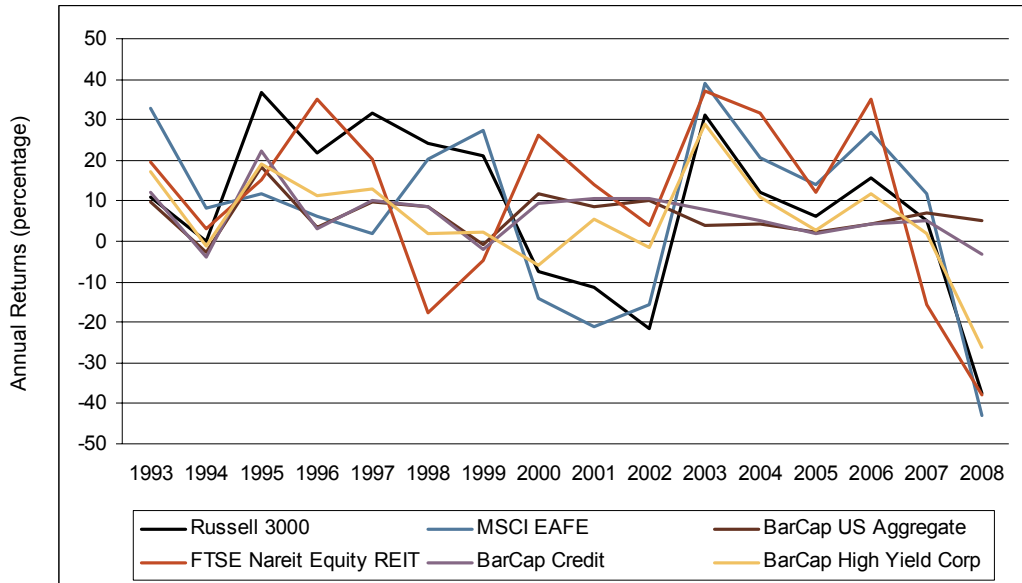
- Perhaps the world has changed for good in terms of the risk/reward tradeoffs available in financial markets. If so, it is possible that longstanding allocations may be no longer appropriate.
- Maybe the turmoil in financial markets and the overall economy has materially changed *your* circumstances to such a degree that your current asset allocation no longer suits your objectives. For example, if you are currently in retirement, you may have trouble maintaining your current spending level due to the diminished value of your portfolio. If, on the other hand, you are still employed and saving for retirement, your future prospects for earning and saving may have been hampered. Your current plan may have been predicated on a steady stream of income and saving until retirement, but those assumptions may be no longer valid due to changes in the workplace or your future employment prospects.

Normal risk/reward relationships will return

The challenge, especially during times like these, is to differentiate between *logical* reasons to change your allocation and *rationalizations* to give in to your natural instincts that relentlessly scream at you at seemingly earsplitting volumes: “DO SOMETHING!”

¹ Asset allocation does not assure profit or protect against loss in declining markets.

With regard to bullet number one, I do not believe that there has been an irreversible or permanent change in the long-range risk/reward tradeoffs of financial markets. Put simply, don't panic—generally, what was once normal will return. For all that's gone wrong, I feel that the expected returns of the major asset classes have not changed. Furthermore, the increases in volatility as well as the parallel behavior among asset class returns (i.e., fixed income securities being down sharply along with stocks) that occur amid severe financial crises are anticipated and, most important, history shows that they are often temporary.



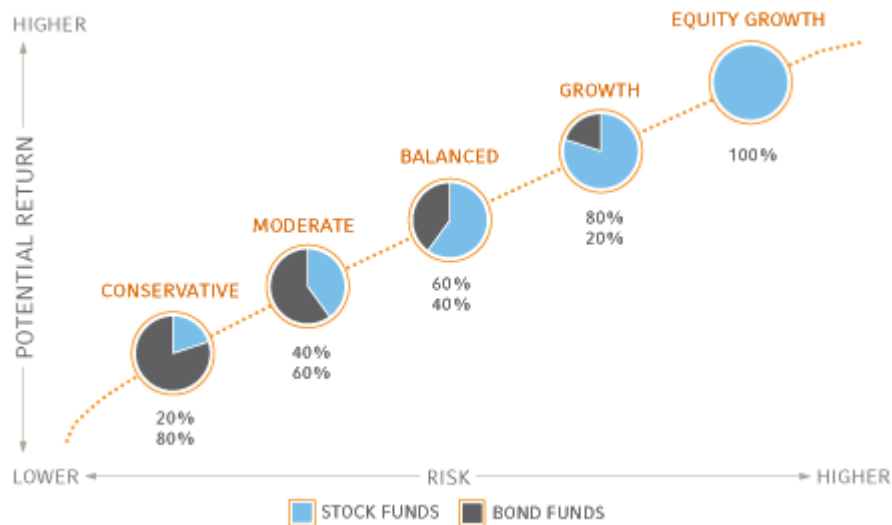
2008 was a year in which most fixed income categories failed to serve as a counterbalance to the poor performance of equities, as they have historically done.

Indexes and/or benchmarks are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

Instead, when considering potential changes to asset allocation in response to recent events, an investor should focus on quantifiable factors such as reduction in wealth and possibly diminished economic prospects that could limit future saving. Using this approach, I will describe some factors that can help you and your advisor decide whether changes in your asset allocation make sense. First, to help you understand when to do what, let me briefly explain how I believe an asset allocation should be determined in the first place.

Finding the right blend of risk and reward

The traditional process for finding an asset allocation that's right for you revolves around what academics refer to as the "efficient frontier" model. Each point along the efficient frontier (see diagram on next page) is associated with a portfolio allocation that gives the greatest reward for a given amount of risk. The efficient frontier is a useful concept and, when accompanied by a risk tolerance questionnaire, can help you and your advisor determine which efficient frontier portfolio is the right one for you.



By the same token, this time-tested approach may not be sufficient by itself to address new realities, such as how your choice might be impacted by a major change in your employment circumstances. That is because neither current wealth nor savings are factored into the efficient frontier framework.

What's needed to address the current environment, therefore, is a more practical, results-driven method for determining whether the recent market turmoil should lead to a change in asset allocation. To make the asset allocation adjust to current realities, it needs to take into account such variables as your age, wealth, risk tolerance, income prospects and spending plans (as well as perhaps other factors unique to your individual situation) And, of course, if you are still saving, the equation must factor in your anticipated stream of savings between now and retirement, at which point income accumulation will most likely cease.

For younger investors, time is on your side

Despite the temptation to “do something” in times of economic tumult, when it comes to asset allocation, younger investors decades away from retirement might be wisest to sit on their hands. Younger investors are usually less vulnerable to the long-term impact of fluctuations in current wealth since most of their retirement wealth will come from future earnings and savings and the returns on each. Therefore, for young investors whose ability to earn and save has not been significantly harmed by recent events, the long-run behavior of markets is what matters, and I believe that expectations about the long-term forecasts of returns should be relatively consistent with historical norms. Bear in mind, however, that if you are a younger investor whose prospects for earning and saving have been reduced due to recent events, you may, in fact, need to reduce the risk in your asset allocation.

The bottom line: a major loss of wealth is less critical for young investors with years of future savings to look forward to than it is for investors near retirement. Consequently, younger investors are less likely to have to change their asset allocation in response to severe market downturns. If you're young, time is still on your side.

Adjustments may be prudent for investors in or near retirement

For retirees and those near retirement, staying the course will make sense if your spending plan was so conservative relative to your wealth that you are still likely to have enough money to live on even after the recent market meltdown. Retirees in this situation are essentially investing to preserve their estates rather than looking to grow them. Their time horizon is long.

If you are near retirement or presently retired and have experienced a significant decline in your wealth, it may be appropriate to reconsider your asset allocation.² Furthermore, if the decline in your wealth is substantial enough to increase your risk of running out of money without a change in your spending pattern, then it may well be advisable to reduce the risk of your portfolio (and perhaps lower your spending plans to coincide with your wealth and current allocation).

Learning from a year we'd like to forget

In 2008 the financial markets taught us all some important and expensive lessons.

First, for those who plan on supporting themselves with the wealth they are accumulating now, investment success or failure should be judged in terms of the ability to fund a desired standard of living, not in terms of achieving some arbitrary benchmark.

Second, for retirees, asset allocation is not an abstract statistical exercise. Risk is not standard deviation of return. Put simply, risk is the chance that we will run out of money before we die.

Third, financial markets are capable of surprises, many of them nasty. We need to be humble and allow for our ignorance in trying to design strategies that will be entirely bullet-proof versus the worst-case scenarios we cannot even imagine.

Asset allocation is our primary tool in overcoming these challenges. Perfection simply does not exist but fortunately, we do have the knowledge to design and manage effective asset allocations. It's no longer a simple world of set your allocation and forget it. There may be times when change is needed. However, a focus on goals, sound financial thinking, and discipline in action remain the hallmarks of solid asset allocation.

² Changes in your spending plan and age should also cause you to reconsider your investment portfolio. Of course, age will not change unexpectedly. However, age is just a proxy for life expectancy. A change in life expectancy could alter your plan.

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