

## **DOES ASSET ALLOCATION NEED A FACELIFT?**

*Has the 2008 stock market changed the rules of asset allocation and how we manage asset volatility?* By David J. Drucker

With the 2008 stock market exhibiting unprecedented volatility, do we need to completely overhaul our notion of asset allocation? And how can we better assure that portfolios created to help clients reach retirement by a given date will actually accomplish that objective?

These are the questions I posed to three recognized experts in the advisor community: Roger Gibson, chief investment officer of Gibson Capital LLC in Wexford, Pa.; Lou Stanasolovich, president and CEO of Legend Financial Advisors Inc. in Pittsburgh; and Tom Connelly, president and chief investment officer of Versant Capital Management Inc., which has offices in St. Paul, Minn., and Phoenix.

When we think back on equity market activity in 2008, we'll first remember the sheer loss of value that occurred and next the extreme volatility. Gibson provides a fascinating look at the latter. "I've never seen markets move as frequently and sharply as in the last few months of 2008," he says.

Gibson instructed a staffer to look at movements in four indices—the S&P 500, the Morgan Stanley Far East Index, the NAREIT index and the Goldman Sachs Commodities Index. "We looked at each index to answer the question, 'How many trading days did the index gain or lose 5% or more?' We found that from January through August of 2008, the S&P and international markets had no 5% trading days, while REITs and commodities had seven and five days, respectively." But afterward, from September to December, it was another story altogether. Gibson found that domestic stocks during this period moved by 5% or more on 18 different trading days. The number of days it moved by that much for internationals, meanwhile, was 28, while for REITs it was 46 and for commodities, also 18.

"There were only 85 trading days during the latter period, so commodities for example moved 5% or more over 50% of the days in that four-month period. I've never seen anything like that and I think it will hang around for a while, but I'm not sure it will translate into a significantly different standard deviation when measured on an annual return basis. And from a portfolio construction point of view, we allocate based upon annual return data."

So what are we saying here? Was 2008 unpredictable in the context of historical stock movements?

"No," claims Gibson. "If you look at Ibbotson data on the U.S. market from 1926 forward, the simple average return on the S&P is roughly 12%. Even if you assume a normal distribution, you'd expect 95% of all annual returns to fall within two standard deviations. One deviation is 20%, so two deviations give us a range of -28% to +52%. The remaining 5% of all observations would fall outside that range—half below and half

above. Including 2008, the S&P fell below that range on three occasions—in 1931, 1937 and 2008. So that's pretty much on the mark. 2008 was a crazy year, but did anything crazy happen? We know those balls are in the urn, and one of them was picked."

Connelly agrees 2008's volatility was not unexpected. "In the '60s, Mandelbrot and Fama found stock markets, especially in the short run, are more volatile than our models predict. In other words, we've known this was possible because it's been in the serious literature for more than 40 years now."

What fascinates Connelly is that our age-old models for determining stock value didn't predict the 2008 market. He says, "The weird thing about this crisis we're in is there were signs in the economy, such as obvious problems in the mortgage markets, but none of the stock markets were crazily priced based upon conventional valuation metrics. They were a bit expensive based upon peak earnings metrics, but nothing like in 1999-2000. So this whole thing came out of the blue; if you'd run some valuation model, you wouldn't have seen it coming."

And even if you did, where would you put your clients' money, other than cash? Says Gibson, "We looked at the Morningstar database of 3,734 funds invested primarily in U.S. stocks and all but one lost money; the 978 in non-U.S. stocks all lost money; the 144 domestic and foreign real estate funds all had negative returns; and 128 natural resource funds all lost money. In other words, of over 4,000 equity funds, all but one lost money."

Which means, in order to protect your clients, you would have had to time the market and go to cash—something most serious advisors are hesitant to do. Or would you have? Stanasolovich says the 2008 stock market losses haven't moved his clients' retirement targets.

"I don't think we have any clients who won't be able to retire on schedule," he says. "Some might need to change their lifestyle a bit, though." As far as his clients' losses, he says, "Some were down as little as 6% last year, others were in the 9%-10% range, and the worst situations—in all-equity portfolios—took a 15% loss."

He attributes his low numbers to his use of managed futures, long-short commodities, and the switch to high-quality bonds. As the editor of the Risk-Controlled Investing newsletter for advisors, he believes we haven't seen an economic situation like the one we're in since the Great Depression and, hence, we need to invest as if this were the 1930s, using strategies such as heavy shorting, buying very high-quality bonds, avoiding equities and sitting on large amounts of cash. "In our most conservative client portfolios, we've got 40% in cash, and no less than 15% in less-conservative portfolios," he says.

"We've become convinced we should be using managed futures in almost every portfolio, for almost any scenario we can envision. We were doing this before the current market, but we've now become more comfortable with these strategies and we're creating hedged portfolios with what is predominantly a managed future strategy."

The question remains: Do we need to completely overhaul our notion of asset allocation in light of current events? Connelly says it's not a matter of modifying one's asset

allocation philosophy, but of implementing the one we've already got. "I have major categorizations of asset classes, like most advisors, but what's important is to always make sure there's something material in each bucket so we haven't overweighted stocks, bonds, gold, whatever. The other thing is to say not only do we not know the future returns or volatility of particular assets," he continues. "We don't even know the distribution curve that best describes them in the future. If you think stocks too risky, then you might try to guarantee some income streams against market volatility with guaranteed products or fixed annuities, for example."

Gibson essentially concurs. "I think the one thing asset allocation promises and which it has delivered is to make the portfolio, as a whole, take on less average risk and have a higher compound return than the average return of its asset classes," he explains. "Yet it doesn't mean you can't get into a scary environment, and asset allocation won't eliminate all risk on the downside."

Stanasolovich has a somewhat different take: "For us, asset allocation has always been more strategic in nature, where we might add or sell a few funds each year, but now we're feeling the need to be more tactical in our allocations and radical in terms of the time frame in which to make changes."

For example, he says, in late September/early October, Legend felt the need to move quickly with sales of equities. "And virtually everything we sold went down more after the sale," he says. "We then made sure every portfolio [except all-equity portfolios] had managed futures exposure. Yet we realize that not every client can be pigeonholed, so although the majority of our clients get lower-volatility strategies, many have other portfolios we run at an increased risk level."

For example, Legend's "Ultra-Conservative Lower Volatility Portfolio," which has 75% cash and debt to 25% equity, includes equity line items like Undisclosed Managed Futures L.P. and Caldwell and Orkin Market Opportunity. The firm's "Aggressive Lower-Volatility Portfolio," at the other extreme, is 26.5% cash and debt and 74.5% equity, the latter including securities such as Diamond Hill Focus Long-Short and Rydex Managed Futures. So while Stanasolovich has moved to a more tactical approach to asset allocation, he's still an asset allocator.

Perhaps traditional asset allocation doesn't need a total face-lift, say these experts, but there are times when it simply can't protect against wide-scale portfolio devastation. As Gibson says, that marble that represents a plus-two-standard-deviation downside return is in the urn waiting to be picked on occasion. When that happens, he says, his favorite quote by Paul Volcker, past chairman of the Federal Reserve, comes to mind: "You cannot hedge the world." "I love that quote," says Gibson. "If you're living on this planet, you can manage risk, but you can't eliminate it. That was the essence of Volcker's comment, and we learned that lesson in 2008."

An independent advisor since 1981 and journalistic voice since 1993, David J. Drucker, MBA, CFP® is a frequent speaker at industry events. To learn more about his availability for your next event, contact him through [www.DavidDrucker.com](http://www.DavidDrucker.com).