



The Failure of Asset Allocation

OVER 20 YEARS ago, a landmark paper was published by Gary Brinson, Randolph Hood, and Gilbert Beebower. The paper attributed the variation in the total investment returns to three factors: asset allocation policy, market timing, and security selection. The study found that asset allocation was the overwhelming dominant contributor (91.5%) to the total return of an investment portfolio. Choosing the right stock or mutual fund was not the answer (4.6%), while market timing proved even more inept (1.8%). The dramatic results supported the notion that the asset allocation decision was the primary determinant of investment performance. These findings were subsequently confirmed by other major researchers, and the overall impact was groundbreaking. The study was especially embraced by our own industry. No longer would an advisor have to be an expert as a stock or mutual fund selector, but could now concentrate on the merits of asset allocation. Legions of advisors became asset allocation advocates. Glossy brochures and pie charts were developed to promote the new strategy. After the study's prominence was declared, an investor walking into an advisors' office was sold asset allocation as the ultimate cure-all.

By the early 2000s, asset allocation pie charts became quite robust, featuring no less than nine separate asset classes. Real estate investment trusts (REITs), foreign bonds, commodities, and precious metals started to become staples in a sample asset allocation plan. Many advisors thought that these more sophisticated asset allocation plans offered a

stable level of return while reducing the chance of loss. Most important, they believed these new-age portfolios would sail through the worst markets.

During the 2000-2002 bear market, the asset allocation train steamed along, and those investors that followed their wise advisors that promoted asset allocation were heartily rewarded. As we came out of the 2000-2002 bear market, investors who had been burned in the Internet

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bubble suddenly became love-struck with appropriately diversified portfolios. Unfortunately, too many of us believed that these updated asset allocation plans were impervious to severe future stock market declines.

Of course, just when you think you have the capital markets figured out, they do something quite unexpected. The unexpected started in late 2007: a full-blown banking and liquidity crisis. As even the most sophisticated asset

allocation plans did not account for such a Depression-era scenario, investors have suffered mightily.

In examining all the major asset classes over the past 52 weeks, only U.S. Treasury Bonds provided a positive return. The projected benefits of adding small cap and international stocks to a diversified portfolio have vanished during this market decline. With the collapse of real estate, REITs have not helped. Commodities and precious metals have also suffered dramatic depreciation. According to the experts, these asset classes were supposed to zig when the others zagged.

What went wrong? First, asset allocation, no matter how sophisticated, is no panacea. Asset allocation can explain past market performance, but not predict which allocation will work in the future. Although correlations of assets are fairly predictable over time, correlations can be extremely unpredictable over shorter time periods. For our own industry, it is a lesson to be learned. Our industry has preached and sold the merits of asset allocation for nearly 20 years. For the industry and its professionals, it is time for a frank discussion with clients on what asset allocation truly means: Not only what it can do, but more important, what it cannot.

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