

Diversified Asset Allocation

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The purpose of this white paper is to demonstrate how diversified asset allocation can be applied successfully to changes in the economy's seasons.

Flawed forecasting leads to less diversification, diminished returns

Even when investors know and understand the methodology of asset allocation, they often fail in their investments. A main cause of this failure involves the Human Model of Forecasting. People tend to forecast trends as straight-line extrapolations from the past, even though trends move in curvilinear or cyclical patterns.

The principle of diversification represents the best single way of reducing risk while aiming for strong, long-term returns.

This tendency to forecast in a straight line causes investors to be the most optimistic and risk-accepting at the top of a cycle, when likely the greatest risk and negative returns lie ahead. Then those same investors become the most pessimistic and risk-averse at the bottom, when the markets have washed out—discounting that the worst of the risk taking has passed and the longest periods of high returns typically lie ahead.

The inclination to project the recent past into the future not only makes many of us terrible investors but it also causes bubbles to develop near the tops of very robust markets, just as it did in 1987 and 2000. The bubbles with unrealistic valuations develop to the greatest degree in the sectors that were strongest during the up-trend in the cycle.

Most investors buy more of the hottest sectors and less of sectors that they may have previously included in their portfolio for diversification of risk. Hence, investors abandon the principle of diversification that actually represents the best single way of reducing risk while aiming for strong, long-term returns. As a result, many investors get into the highest risk positions just before a major correction; they then suffer the worst of the downturn and put themselves in the lowest risk position by selling out just in time to miss the returns of the next rebound.

Wealth Insight: Confusion often stems from the interchangeable use of the terms asset allocation and diversification. Asset allocation simply means determining what proportion of your money is going to be invested in each asset class—stocks, bonds, cash investments—in order to maximize the growth of your portfolio for each unit of risk that you take. Diversification is simply adding more names/investments into the same investment category.

Asset classes: What percentages should you choose?

So how do you actually determine what percentage of each asset class you should own? Academics have calculated methods to measure correlation in a portfolio, thereby enabling the volatility or risk of a portfolio to be measured with a degree of predictability. Your wealth management advisory team should have access to these types of tools.

Because of these measurement tools, it's possible to combine a portfolio of asset classes that have the potential to generate higher returns due to their volatile nature, but whose market performances have a low correlation to one another. This achieves the result that the portfolio as a whole will actually be less risky than any one of the individual investments, yet it will generate a higher overall return than a portfolio made up solely of low-risk investments. Figures 1 and 2 below illustrate inefficient and efficient diversification.

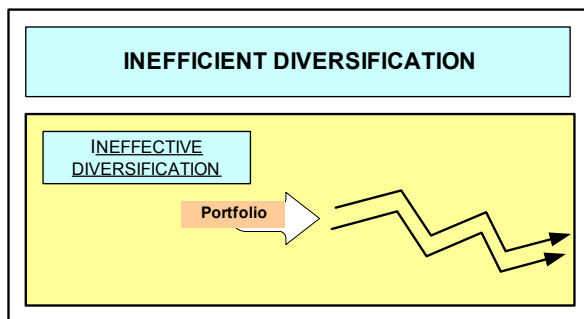


Figure 1 - Inefficient Asset Diversification

What You're Looking At: The progression of investments that move in tandem.

What This Tells You: Ineffective diversification results when all of your investments move together.

What This Means: You put your portfolio at risk when you don't diversify well.

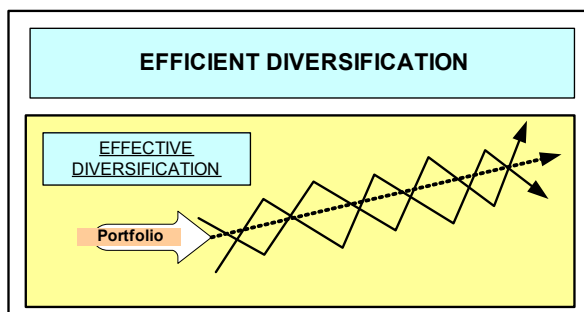


Figure 2 - Efficient Asset Diversification

What You're Looking At: The progression of investments that move independently.

What This Tells You: When each of your investment vehicles moves independently, you can accomplish effective diversification of your portfolio.

What This Means: **The idea of effective diversification may seem simple and unimportant, but it can have a big impact on your returns!**