Sigma Summaries

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At the End of the Day, An Investor Only Has One Portfolio Part I

The following question and answer discussion is the first in a series focusing on the determinants of investment returns. They also address what Sigma believes is the investment advisor's primary responsibility; i.e. to maximize each client's long term after-tax real total rate of return consistent with each client's risk tolerance. In the first interview with Ann J. Conrad, she discusses the role of asset allocation in the determination of investment returns.

Ann, what do you think are the most important factors that determine an investor's returns?

The single most important factor that impacts an investor's investment returns is asset allocation. We know from the last two hundred years of history that the asset that has provided the highest return over the most long-term time periods has been common stocks. In making this statement, I am including not only financial assets such as bonds and cash equivalents, but also hard assets such as real estate, art, and commodities.

The superiority of stocks to other investments over history is indisputable. Over the past 200 years the compound annual real return on U.S. stocks is seven percent. No other asset has exhibited such returns. Furthermore, real stock returns in other major countries have matched those in the U.S. Stocks have also displayed remarkable consistency in providing superior returns.

Surely, there have been short-term periods and even considerable periods of time such as the depression and the 70s when stock returns have been sub par or even negative due to political or economic instability. But time and time again, stocks have demonstrated remarkable resiliency. Favorable market behavior has occurred despite the dramatic changes that have taken place in all the major societies during the last two centuries.

The reasons for the persistence and long-term relative stability of stock returns probably are many. Suffice it to say that superior returns are mainly a function of the triumph of free-market economics in a growing number of nations. The robustness of world equity prices in recent years might reflect not only the emergence of the golden age of capitalism, but also the impact of a technology and telecommunications revolution. The question for investors, then, is whether there is any reason to think stocks will not remain the long-term asset of choice.

Ann, let's just assume for the moment that stocks continue to have the best rates of real returns. The preface to this article indicates that Sigma believes the investment advisor's job includes taking into consideration an investor's tolerance for risk in the asset allocation process. Your comments above suggest you would advise clients to invest as high a percent of their wealth in equities as possible. What if their tolerance for risk is low?

Portfolio Theory describes how to alter the risk and return of a portfolio by varying the proportion of each asset. This assumes different assets have different levels of risk. The most efficient portfolio for an investor is one that provides the highest level of return for the least amount of risk. In this framework, risk is defined as the standard deviation or volatility of returns of each asset. This is the measure of the day-to-day or month-to-month fluctuation in market value.

Using this definition of risk and considering financial assets only, cash would have the lowest level of risk, then bonds, and stocks the most. Therefore, risk averse investors would have an all cash portfolio, those willing to assume high risk would have an all stock portfolio and may even employ margin to take greater risk. This is the heart of portfolio theory and management, and the foundation of many asset allocation models.

Risk can take many other forms as well. There's the risk that a single company goes bankrupt or defaults on its interest payments, thus hurting owners of the company's stocks and bonds. This is business risk. There's the risk that you sell stocks prematurely, only to see stocks roar ahead. There's a risk that you panic when stock prices drop, locking in losses, only to see stocks rebound. These are market risks. There is risk that stocks will fall because of inflation or rising interest rates. This is interest rate risk.

All of these risks pale beside the biggest risk of all -- the risk that the value of your money will get whittled away by inflation and taxes so that you cannot meet your future obligations, including sufficient retirement income. Investors may have to accept the short-term volatility of stock prices and other risks associated with stocks in order to accumulate wealth long term and meet their long-term financial objectives. This means investors also have to correctly define their time horizons before making investment decisions. For the period 1926 to 1999, stocks produced a higher cumulative return than any other financial asset 62% of the time assuming a one-year investment time horizon, 78% with a five-year time horizon and 81% over a ten-year time horizon. History provides compelling reasons to take into consideration one's time horizon before making investment decisions.

It is not unusual for retired people to assume their asset allocation should favor bonds in an attempt to become more conservative in the management of their portfolios. This may be ignoring a time horizon that can be as long as 30-40 years. It takes a lot of assets to support an attractive lifestyle for that long, not to mention possible costly health care needs.

So why not put all of one's assets in equities?

For two reasons. First, there may be liquidity needs that are anticipated or unexpected. We recommend putting aside three years' worth of these needs in fixed income securities that mature as the needs arise. This protects the investor against having to liquidate stocks in a down market. As fixed income assets are depleted, we replenish these reserves by selling some of the equity assets when the market is strong. Keeping some assets in fixed income securities also protects against unexpected liquidity needs.

Clearly, equities are the asset of choice for the long-term investor. However, let me explain the second reason why we would hesitate to recommend investing 100% in equities for most people. Conventional wisdom suggests that over a long enough period, there is no risk in equities. This mantra is a dangerous thinking trap. The reasoning goes that volatility is only a short-term phenomenon and it averages out over time. In other words, if you are indeed a long-term investor, you can overcome this volatility. Therefore, be 100% invested in equities. Why not leverage up to 200%? All you have to do is survive the dips. That's the rub. Maybe you will not always survive the dips. Perhaps the dips will be so prolonged that you will deplete your assets before a market upturn resumes.

In summary then:

- ***the most important decision affecting investment returns is asset allocation***
- ***the most important risk is not meeting one's long term financial goals, not volatility***
- ***it's important to define one's time horizon correctly before making investment decisions***
- ***the name of the game is to match assets with both short term and long term needs and objectives***

Precisely!

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